S. HRG. 100-155, PT. II

DEFINITION OF INSIDER TRADING

HEARING

BEFORE THE

SUBCOMMITTEE ON SECURITIES

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

ON

PROPOSED LEGISLATION TO CLARIFY THE LAW ON INSIDER TRADING WHICH WILL PROVIDE EVERY PROFESSIONAL AND FIRM ENGAGING IN THE SECURITIES BUSINESS, AS WELL AS EVERYONE ELSE, WITH A SINGLE STATUTE TO DETERMINE WHAT THE LAW IS AND WHAT THEIR LIABILITY IS IN THE AREA. PROSECUTION WILL BE EASIER AND PUNISHMENT WILL BE TOUGHER WHEN THE LAW IS CLEAR

PART II

AUGUST 7, 1987

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DEFINITION OF INSIDER TRADING
PART II

FRIDAY, AUGUST 7, 1987

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, DC.

The subcommittee met at 10 a.m. in room SD-538, Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the subcommittee) presiding.

Present: Senators Riegle, Proxmire, Sasser, Shelby, Wirth, Armstrong, D'Amato, Hecht, and Bond.

OPENING STATEMENT OF SENATOR RIEGLE

Senator RIEGLE. The subcommittee will come to order.

We welcome our witnesses today and apologize for being a little late. I was in the process of finishing an interview over the telephone with the Michigan Broadcasters who are meeting in their annual meeting back in Michigan and just as I was about to finish and get up here they asked a question about the fairness doctrine and we had a little difference of opinion on that, so by the time we finished that discussion it pushed us a little past 10 a.m., so I apologize to my colleagues and to the witnesses.

Today we are holding our third hearing on a statutory approach to clarify and define the law on insider trading. Earlier this summer, on June 17, I introduced S. 1380, together with my colleague and friend, Senator D'Amato of New York, which was carefully drafted with the assistance of a group of top securities lawyers representing a variety of points of view.

Our effort has attracted widespread support for a definition from prominent law enforcement officials, including Rudolph Giuliani, in the Southern District of New York, the securities industry, the Chairman of the Federal Reserve Board Alan Greenspan, and the SEC, as well as many others.

In fact, Mr. Giuliani has publicly gone on record as supporting our bill, S. 1380.

This morning we will consider a suggested revision of S. 1380 submitted to us by the SEC at our request. At our hearing on June 19 we asked the Commission to come up with its specific proposals within 60 days and I am very grateful for the work of the Commission and want to thank them for acting to meet that deadline which they have done.

Naturally, the Commission has a vital interest in participating in the legislative process to better define insider trading and their comments and expertise are most welcome and important and necessary to our efforts.

I want to say again at this point that the intent of our initiative is primarily to clarify and to codify in a single statute the principles of insider trading law based on developments through numerous cases and enforcement actions over the years. It is important that the final product provides clarity and has the effect of protecting the integrity of the markets.

It is also my strong hope and feeling that we, with a clearer and more direct definition of insider trading, can help cut down on the abuse that we have seen in insider trading activities and also to make sure that people know what the law is, so that they can comply with the law properly but should they fail to do so be subject to a more certain punishment and very strong penalties, and we provide for that as well.

So this morning we are going to be considering the SEC's comments with the assistance of some of the principal drafters of S. 1380, Harvey Pitt and John Olson and Theodore Levine. We will also be hearing from Richard Phillips, who worked on S. 1380 as well as on the Report of the New York Stock Exchange Legal Advisory Committee's "Proposed Statutory Definition of Insider Trading".

We are confident that our initiative will continue to proceed toward a clear and objective description of the current law on insider trading which will benefit everyone involved.

Finally, the new Chairman of the SEC, David Ruder, has written in response to a question I submitted to him at his confirmation hearing of his concern that "the reach of the law as it currently exists not be reduced but be expanded in certain respects and that fairness considerations be included". Mr. Ruder's explicit and timely suggestions on legislation which would accomplish his stated objectives are most welcome within the context of S. 1380, the legislation that is currently before the subcommittee.

There is now widespread acceptance of the notion that legislation is needed in this area and I am very pleased with the progress that we have made in what is admittedly a most difficult area.

Now let me call on my colleague, Senator D'Amato.

Senator D'AMATO. I do have an opening statement, Mr. Chairman.

OPENING STATEMENT OF SENATOR D'AMATO

First, this morning the subcommittee is conducting its third and perhaps most important hearing regarding a statutory definition of insider trading.

As is the case with most hearings where we discuss the differences between various legislative proposals, this morning's will accentuate the differences between the three proposals before us. By dwelling on these differences some observers of these proceedings might miss what I believe is the real news being made here today. Today's hearing marks the first time when the subcommittee has been able to address a formal SEC proposal and a proposal from

the New York Stock Exchange as well as its own proposal. While we discuss the differences, we will naturally tend to ignore the many similarities between these three proposals. I view the existence of so many similarities between the proposals as a very positive development.

For those who argue that there is no need for a definition, I cite a quote from the New York Stock Exchange report which articulates my views on the topic. "Irrespective of whatever the Supreme Court decides in the *Winans* case, you need a definition. The misappropriation doctrine is so laden with arcane concepts and artificial dividing lines that the layman couldn't possibly understand what's permitted and what's prohibited."

This sentiment was echoed in previous hearings before the subcommittee by four top executives of major investment banking firms when they had trouble defining the point at which permitted conduct stops and prohibited conduct starts. Ultimately, Congress must bear the responsibility of drawing this line. However, while drawing it, we must be careful that our efforts to maintain the integrity of the market do not debilitate it by legislation that impedes the free flow of legitimate information that is the lifeblood of our financial system.

Since the passage of the Insider Trading Sanctions Act, I have believed that a statutory definition is needed. Since 1983, I have maintained that the "I know it when I see it" standard is just not adequate. As many of my colleagues in Congress demand that the SEC and the Justice Department produce the heads of those who frequently flout the securities laws, they often overlook the legal difficulties in prosecuting those cases.

As the Government has begun to prosecute vigorously such violations criminally and courts are empowered to impose treble penalties for civil violations, the accused are not going to roll over like they did when disgorgement alone was the SEC's only real penalty. Those accused of insider trading will attempt to exploit the vagaries of the misappropriation theory which have evolved from the general antifraud provisions of the Federal Securities Act. Therefore, a statutory definition of insider trading should be designed to facilitate the prosecution of these cases as well as drawing the line between permitted and proscribed conduct for market participants.

Attempting to formulate such a definition is far easier said than done. A careful reading of the three proposals reveals that they all contain a type of internal tension. This tension is created by the need to prohibit illegal trading activities resulting from the wrongful use of information without interfering with the free flow of investment information to the marketplace.

And although the resolution of this tension has proven a difficult task, each proposal successfully defines insider trading in a manner that furthers the full disclosure policies of the Federal securities laws.

I appreciate the testimony of this morning's witnesses and especially would like to commend the SEC for submitting its proposal to this subcommittee in a timely fashion. I also appreciate the leadership in the area that the New York Stock Exchange has demonstrated by proposing its own definition to the subcommittee. Hopefully, the differences among the proposals will be reconciled during

the recess and the subcommittee can consider this legislation upon Congress' return in September.

Thank you, Mr. Chairman.

Senator RIEGLE. Thank you, Senator D'Amato.

Senator Shelby.

OPENING STATEMENT OF SENATOR SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

I want to commend you for your continued leadership in addressing the pressing need to curb insider trading and I look forward to hearing Chairman Cox's explanation of the long awaited SEC definition of insider trading. I hope you found it when you recognize it, et cetera.

During the hearings this subcommittee held in June, I expressed concern about the presumption of wrongful action contained in the measure. My subsequent research has revealed that this concern was well founded. The Supreme Court declared in the 1985 case of *Francis* v. *Franklin* that a mandatory presumption, even if it may be rebutted, is generally unconstitutional, depriving the accused of due process of law.

I greatly appreciate the effort of Mr. Pitt and Mr. Olson that I've worked with to address the constitutional problems in the originally proposed bill. I look forward to discussing their views later today with them here in the committee.

I will work to develop a definition of insider trading which respects the right to due process of law. We can protect this principle and I believe establish a law which forcefully combats insider trading, but I believe that the definition that we find must have a delicate balance. If the law is too broad, it can restrict free trade. If it's too loose, it's obvious that shrewd operators can find loopholes.

I once again welcome our distinguished acting chairman here today and look forward to his testimony.

Senator RIEGLE. Senator Armstrong.

Senator ARMSTRONG. I pass. Thanks, Mr. Chairman.

Senator RIEGLE. Senator Hecht.

OPENING REMARKS OF SENATOR HECHT

Senator HECHT. Thank you very much, Mr. Chairman.

When I came to the U.S. Senate the word was Congress is a deliberative body. I'd like to add something more to that. Congress is an overreaction body. We overreact to the morning news. We overreact to the newspapers. I serve on the Intelligence Committee. Right now there's more legislation because of an overreaction to problems in Central America and the Middle East. Everyone right now is worried about the stock market in Washington, but somehow, outside of Congress, people around America are not worried. They are saying that there's a lack of confidence. My God, I would hate to think what would be happening to the stock market today if it had any more confidence.

So I think as we move on to this legislation, let's proceed very, very cautiously. Let's proceed and reflect and think that this stock market is what built America, our great industrial base, and before we tear and reinvent a new wheel, let's be quite careful.

Thank you very much.

Senator RIEGLE. Thank you, Senator Hecht.

Senator Wirth.

OPENING STATEMENT OF SENATOR WIRTH

Senator WIRTH. Thank you very much, Mr. Chairman.

As you know, I have very real questions about our proceeding in this particular area. I can be persuaded, but I am very skeptical.

We've had a long history on the definition of insider trading. You remember that in 1983 when we passed the Insider Trading law there was a great debate as to whether we should change and work on the definition of insider trading. And we ended not doing so for a couple of reasons.

One, we could not reach a consensus on where that point ought to be. There simply wasn't any consensus at that point even with our good friends from the ABA and the securities bar groups working as hard on it as they did.

Second and more importantly, we did not get to a consensus because a lot of us believed that working out a specific wording on insider trading could well be an open invitation to a lot of very smart lawyers. They could say, "OK, this is what they mean by insider trading by definition and we're not doing that, so therefore everything we're doing is perfectly appropriate."

And I still carry that skepticism. Maybe the ABA and the good gentlemen testifying today can come up with a definition that's going to get a greater consensus, solving our first problem. The second one remains. Even if we define it, is that not going to be an open invitation to abuse?

Finally, just in terms of the priorities that we face, Mr. Chairman, we are all aware of the fact that we have in front of us a mergers bill that we have to be thinking about and there's been a lot of work gone into that, and a lot of discussion still to be done. And that on a 10-point scale it seems to me is about a 2 or a 3, compared to the big job we have to do, which is the reexamination of the laws that govern our financial institutions, which is a 10.

This is an enormous task in front of us, to look at Glass-Steagall and all of the related law. And I just have a real foreboding that we're going to get into this, which is I think of minor importance compared to the mergers bill which is of greater importance compared to the financial institutions bill which is very, very large indeed.

So if we're going to do something, let's do it rapidly. I don't think we can do it rapidly. I am extremely skeptical of our ability to come up with something that we can agree upon, particularly with the court considering in the fall the *Winans* case which is going to be very important to our deliberations. I think we have to be sure to have asked the SEC if a definition or a lack of a definition has inhibited their enforcement. I don't think it has.

I think we have to get all that evidence in and we've got an awful lot to do and I appreciate your efforts and concern on this. But I continue to register the skepticism that I had some years ago and had earlier this year and continue to have today.

Thank you, Mr. Chairman.

Senator RIEGLE. Senator Proxmire.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. Thank you, Mr. Chairman.

Mr. Chairman, I share much of the skepticism that Senator Wirth has so eloquently voiced about defining insider trading, but I do want to commend the SEC for developing a constructive proposal. On the whole, I think that the SEC proposal is an improvement over S. 1380. I especially applaud the Commission for proposing tougher requirements for a Chinese wall within securities firms and for holding those firms to a higher standard of liability for the wrongful actions of their employees. There are, however, provisions of the SEC bill that cause me concerns.

When Commissioner Cox appeared before this subcommittee on June 19, he testified that S. 1380 "could impede Government enforcement action," and that the SEC did not support the bill in its current form. He said the SEC would submit its own proposed definition of insider trading. In response to my questions, he went on to state that the Commission wanted to make sure it had a definition that didn't leave "ambiguities or potential problems for the enforcement division."

So I expected the Commission to provide us with a tough definition—a definition that would facilitate effective enforcement. But what have they given us?

Paragraph (d)(3), at the top of page 4, exempts from the prohibition of subsections (b) and (c) "any communication made in a reasonable effort to make the information public." The apparent intent of that is to protect people, like Raymond Dirks, who genuinely seek to publicize inside information. But I'm concerned that the unintended result of paragraph (d)(3) may be to create a field day for clever defense lawyers. I can hear them now, telling the jury that the poor, misunderstood defendant should be acquitted because his tipping-and-trading scheme was really just an abortive attempt to make the information public. Paragraph (d)(3) is an invitation to creative perjury. I question whether it's needed, and I note that S. 1380 contains no similar provision.

I have similar concerns about paragraphs (d)(4) and (d)(5).

I am also concerned about other aspects of the SEC's proposal, such as the studious avoidance of the terms "misappropriation" and "conversion." Those concepts have been at the heart of recent enforcement efforts, and their omission could be viewed as cutting back on existing law.

On a more positive note, I commend Senator Riegle and Senator D'Amato for their efforts to develop a statutory definition, and I hope we can see constructive interaction between the proposals that are now on the table. But I insist that any statutory definition put the SEC's enforcement division in at least as strong a position as it's in under current law.

Thank you, Mr.Chairman.

Senator RIEGLE. Thank you, Senator Proxmire.

Let me just say I think this has been a very constructive set of opening comments and I want to take note of the fact that the subcommittee participation is full and complete today. I think it's sig-

nificant that on a matter of this sort, which is technical and which is complex, that we have here seated seven Senators attempting to deal with it and I'm very grateful for that attendance and I think it says something about the importance of the subject.

I want to stress my agreement with the last comment that was just made. We want an insider trading law that is at least as strong as the one we presently have, albeit the fact that it's vague, unclear, and that this is one of the reasons why we are waiting to find out how the courts would even interpret what they understand the law to be.

Now I want to say with respect to the specific comments of Senator Wirth, and I appreciate what he has said and I appreciate the tone and tenor in which they have been said. Clearly, we are talking about a search for a clarification and a definition that does not come readily or easily. We have to work back and forth to see if we can arrive at a consensus position that is better than our current situation.

But at the baseline it seems we're left with the proposition that a vague law may be better than one that is clearer and more precise. And I just can't buy that, not in the securities area or in any other area of the law. The notion that somehow we should have a vaguely understood statute that can move around, that can change, that can be subject to different kinds of interpretations at different times I think really raises a very fundamental question about justice and fairness in our society.

I think laws ought to be clear and I think we have an obligation to try to make them clear. And if people break the laws, then they ought to be nailed and fully held accountable. We don't write laws forever. We write them until such time as it's clear that they ought to be changed and Congress doesn't meet every 10 years or every 20 years; we meet every year. And if we write a law and events prove that the law needs to be adjusted and changed, then we have to come back and we have to act to do that. We do it all the time.

So there should be no suggestion that in writing a new law that it's frozen and locked in concrete forevermore. If we can come up with a better definition and I'm confident we can, and we should find in 1 year or 5 years that there needs to be adjustments in it, then that's the time to take that action to make whatever adjustments seem to be appropriate.

But clearly we are at a point now where we've got three proposals before us. I think this takes some hand-tailoring now to do some cutting and fitting to see if we can find a way to comprise and to pull these three packages and whatever other thoughts there may be into a single package. I think we can do it. I think we have to try to do it. I think it's important to the country. Everything we do in this committee is important. This happens to be a year in which we have a very heavy workload. We've got hostile takeover legislation, tender offer reform, and financial deregulation issues before the committee. We've had a rash of insider trading activity and a lot of turmoil as a result of that, and when we have three job assignments or five or whatever the number is in a given year, I think we have to do them all. I don't think we can pick and choose and say we'll get this one done but we'll let the others go. I think it's fully within our capacity to do them all. That

doesn't mean we will necessarily be successful, but I think we have to try. And I think if we try in good faith, we'll get there.

Now let me just say, Mr. Cox, you are acting chairman until roughly 1 o'clock today and so this is an opportunity to go out in a blaze of glory as the acting chairman.

Senator WIRTH. Mr. Chairman, if you might yield before we get going with Mr. Cox, I don't want to leave the impression that the Senator from Colorado is for weak law or not for enforcement. I think the record is very clearly to the contrary.

What I am concerned about is it seems to me the proposition that we all live with all the time which is one of a kind of relative weights. What we do is in relation to something else. Everything is relative. We talk about a vague law, that's vague in relationship to what? Is the specifics of the law vague and is that something of concern rather than all of the case precedents that we have under which the SEC is currently enforcing the statute. I think that that has served us very well and that until the evidence is in that it hasn't we shouldn't be nibbling around. We're talking about strong enforcement. Strong in relationship to what? We want to make sure that Gary Lynch has all the tools necessary to enforce the law and to secure the confidence by consumers and we ought to be looking at that.

We also ought to be sure that we are aware of what other events are out there. Winans is occurring and we have to remember that. Again, most importantly, we have a very short period of time under the FSLIC legislation in which to rewrite an enormous amount of law which is going to be extremely difficult. Rewriting this legislation and major points of consensus and variance looks to me like a piece of cake compared to what we have to do on S&L's, banks, investment banking, commercial banking, and insurance.

On a relative balance, I don't want to suggest that what we're after is vague law or maintaining that. I think it's relative to the other chores we have to do here. The rewriting of the law is so very important that I hope that we keep that front and center.

I appreciate your efforts and I know that you and the Senator from New York have spent a lot of time on this. I appreciate the efforts of our witnesses who have worked very hard. Mr. Cox and the SEC have also worked very hard. Again, let me just close—and I appreciate you yielding—by saying everything is relative and I guess my weights are at this point at a little bit of different place.

Thank you, Mr. Chairman.

Senator RIEGLE. Mr. Cox.

STATEMENT OF CHARLES C. COX, ACTING CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION, ACCOMPANIED BY GARY LYNCH AND DANIEL L. GOELZER, SEC

Mr. Cox. Chairman Riegle and members of the subcommittee, the Commission is pleased to testify on its proposed Insider Trading Act of 1987. The Commission has submitted an explanatory statement which I request be included in the record.

Senator RIEGLE. It will be.

[The information referred to follows:]

Mr. Cox. The Commission believes that insider trading undermines the expectations of fairness and honesty in the markets. The Commission also believes that legitimate information gathering is essential to market efficiency. The theft or misappropriation of information is unfair and discourages investment in legitimate information gathering.

Aggressive efforts to eradicate insider trading need not and should not rely on parity of information theories. The Commission agrees with the courts that legitimate market advantages are gained through skill, foresight, industry and the like, but not through purloining or otherwise misappropriating material nonpublic information.

The Commission does not believe that a statutory definition is at present necessary for continued successful enforcement, but recognizes that benefits could result from an appropriate definition.

We have benefited greatly from the work of the group chaired by Harvey Pitt, whose proposal was introduced as S. 1380, and are now able to present a proposal that has the Commission's unanimous support.

The proposed legislation would prohibit insider trading under a new Securities Exchange Act section 16A. Like S. 1380, the legislation builds on breach-of-duty and misappropriation principles embodied in existing law.

Trading would be forbidden while in possession of material nonpublic information that was wrongfully obtained or the use of which would be wrongful. Information is wrongfully obtained or used when it has been obtained by or as a result of, or its use would contribute (1) theft, bribery, misrepresentation or espionage, or (2) a breach of duty to maintain information in confidence or refrain from trading when the duty arises from a relationship with specified sources related to the securities markets.

The legislation also prohibits tipping when the tipper knows that information is material and nonpublic and foreseeable trading results. The tipper is also liable if a tippee tips others who foreseeably trade.

The proposal codifies existing Commission rule 14(e)(3). This prohibits trading by a person other than the tender offerer who possesses material nonpublic information relating to the tender offer where that person knows that the information was acquired directly or indirectly from the tender offerer or the target company.

Subject to specified exceptions, communications of tender offer information are also forbidden.

The legislation expressly permits reasonable efforts to make the information public. There is also a safe harbor for routine communications, but not trades, by or to securities analysts who disseminate the information to investors.

The legislation includes the existing defense to liability for multiservice firms where the employee trading on the institution's behalf did not know the inside information and the institution had reasonable procedures to prevent violations.

The legislation expressly gives contemporaneous traders the right to recover from insider traders or tippers and provides an express private right of action to anyone else injured by insider trading.

Though the similarities are substantial, the Commission's proposal also differs from S. 1380 in a number of respects.

For example, the Commission's proposal avoids inappropriate federalization of duties owed to persons without a significant nexus to the securities markets.

The Commission's proposal generally follows current rules on trading and tipping that involve tender offers, rules it believes work well.

The Commission's proposal requires that, to avoid liability for insider trading, firms have reasonable procedures to prevent it.

The Commission's proposal provides a safe harbor to promote the dissemination of information.

The Commission's proposal treats employers' liability for insider trading the same as for other securities law violations.

The Commission's proposal for an express private right of action is not limited to contemporaneous traders but extends to others who may be injured by a violation.

The Commission's proposal defines insider trading as wrongful trading while in possession of, not on the basis, of material nonpublic information. S. 1380 presently does not, although Mr. Pitt has proposed changes.

The Commission appreciates the opportunity to testify on its legislative proposal and is pleased to assist the subcommittee in its work. Thank you.

Senator RIEGLE. Thank you, Chairman Cox.

I think we'll start with 5-minute rounds and see how it goes here because we have other witnesses that we want to hear from this morning.

In June when you last testified before this subcommittee, you stated that if the Supreme Court "threw out the misappropriation theory, that would make a statute absolutely necessary for the kinds of cases that the SEC has been bringing." I'm sure you recall that quote.

Mr. Cox. Right.

Senator RIEGLE. Yet your proposal omits from the definition of wrongful trading any reference to the misappropriation theory or conversion.

Can you tell us why?

PROPOSAL OMITS MISAPPROPRIATION THEORY

Mr. Cox. Yes. I believe that the way we have approached wrongfulness, requiring either a specified theft, espionage, et cetera, or breach of a duty to keep information in confidence or refrain from trading, gets at the essence of what's involved in misappropriation. How can there be a misappropriation without a breach of duty?

Senator RIEGLE. If that is so, then why not spell that out in the law? I mean, why not go ahead and make that very clear as you've just done here?

Mr. Cox. I would think that perhaps in the legislative history that could be made clear, but I think the essence is that what's wrongful is the breach of duty.

Senator RIEGLE. But you see, this is a very important issue, and if you agree with the point that it may be necessary to have it in

the legislative history, why do we have it one step removed in terms of the legislative history? Why not put it into the law? Why not say what you mean?

Mr. Cox. Well, I guess it was not done with the intent to legitimize misappropriation. It was simply done with the intent to get at a clear definition that provides guidance, and it's the breach of duty that we really regarded as what's wrongful and we wanted to make that very clear.

Senator RIEGLE. I think you, yourself, from what you've already said in response to my first question, have made a very compelling argument for being more specific about it. If it needs to be in the legislative history, I think it needs to be in the law. I'd like you to take a look at that and see if we can't find a way to do that.

Mr. Cox. All right.

Senator RIEGLE. Let me ask you this. What would be the liability of a brokerage firm under the Commission's proposal for the insider trading of one of its employees and how, if at all, does this differ from current law?

Mr. Cox. It is essentially the same as current law. If we are talking about a multiservice firm where the person doing the trading did not know the information and the firm had reasonable and appropriate procedures to prevent a violation of the law, there would be a defense. The same defense exists under the current law.

However, if you're talking about the situation where someone is off trading on his own, then that is the same as the current law, also, liability depends on the existing securities laws, controlling person provisions and common law doctrines of respondeat superior.

Senator RIEGLE. Let me ask you if you can summarize for us the basic policy differences between your proposal and the legislation that we have introduced and I'd like you to really put your emphasis on what you think are really the key proposals and if you strongly feel that there's something that we ought to change in our proposal versus your own I'd like you to try to bring the spotlight right down on that, if you would.

DIFFERENCES IN PROPOSALS

Mr. Cox. The first one I want to emphasize is one that I did point out in my opening statement. The definition should make it very clear that it's trading in possession of material nonpublic information that is prohibited. I think from the standpoint of enforcement it is essential that that be what Congress enacts.

Now as I pointed out, that's not the way it currently is in S. 1380, although Mr. Pitt proposed changes about the time that we testified before. So I think that can be worked out. We see so many arguments that are completely unbelievable—for example, arguments that trading was based on a report that someone read 6 months or 1 year ago rather than on the basis of information acquired recently. I think that we have to say that trading while in possession of the material nonpublic information is where we will draw the line in the statute.

Senator RIEGLE. My time is up. I will follow up when my next opportunity arises.

Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman.

Mr. Cox, in your opening statement you read something that I found interesting and I didn't find it in the submission that you made to us. Your opening oral remarks differ somewhat from your written submission. Would you mind going back? Because I am having some difficulty in reconciling your written statement with your oral statement. It seems that the Commission did vote to come up with a definition, is that correct?

Mr. Cox. Yes, sir.

Senator D'AMATO. Well, let's go back to where you talked about the definition in your opening statement because you seem to suggest otherwise.

Mr. Cox. The opening statement?

Senator D'AMATO. Yes.

Mr. Cox. It was essentially a summary of what I submitted.

Senator D'AMATO. Well, it's a pretty important summary, isn't it?

Mr. Cox. Yes, sir.

Senator D'AMATO. Go back to the beginning.

Mr. Cox. I'll go back to wherever you would like, Senator D'Amato.

Senator D'AMATO. The first paragraph where you start to talk about the definition and the need of the definition because if you read that, it seems to me that you're saying one thing on one hand and another thing on the other hand. Read it.

Do you want to pass it up here and I'll read it?

Mr. Cox. I'll read it here.

Senator D'AMATO. OK, because I didn't get it submitted here and I'd like to hear you give it to us.

Mr. Cox. All right.

Senator D'AMATO. Very slowly because I want to make sure. Maybe I misunderstood.

Mr. Cox. Yes, sir. I believe this is the paragraph you are referring to. "The Commission does not believe that a statutory definition is at present necessary for continued successful enforcement, but recognizes that benefits could result from an appropriate definition. We have benefited greatly from the work of the group chaired by Harvey Pitt, whose proposal was introduced as S. 1380, and are now able to present a proposal that has the Commission's unanimous support." Is that the passage?

Senator D'AMATO. Yes. When you start and you say the Commission does not believe that a statutory definition is necessary for proper enforcement, but then contend that you support the statutory definition proposed by the SEC.

Mr. Cox. That is consistent with what I testified to.

Senator D'AMATO. That's a great political statement. I mean, I might make that on the stump when I don't want to take a position.

Mr. Cox. I'm not equivocating. We have a definition that we unanimously support.

Senator D'AMATO. OK.

Mr. Cox. We also decided prior to my previous testimony that we should go forward with the definition.

Senator D'AMATO. So is the definition necessary?

Mr. Cox. It is not necessary for the enforcement program to successfully proceed, but I think that there are enough other benefits that a definition is a good idea.

Senator D'AMATO. OK. That's what I'd like to get in a more unequivocal form. In the form in which you placed it—maybe I'm misinterpreting it—but it seemed to me to be quite equivocal. On the one hand you say we don't believe it's necessary for proper enforcement, but we're coming forward. Now you're saying to me, well, there are benefits. What are the benefits?

Mr. Cox. The benefits are a number of things clarifying the law, what I was just talking to Senator Riegle about, making it——

Senator D'AMATO. Just tell me the benefits.

Mr. Cox. Making it specific that trading in possession of nonpublic information would violate the law.

Senator D'AMATO. Why is that a benefit?

Mr. Cox. That is a benefit because it removes any doubt in people's mind as to whether it's on the basis of or in possession of.

Senator D'AMATO. Why is that important, removing doubt?

Mr. Cox. I think it's very important.

Senator D'AMATO. Why? Because it would be helpful in obtaining criminal prosecutions?

Mr. Cox. Yes. I think that since people could be sent to jail there should be a clear statement of what the problem is.

Senator D'AMATO. Good. Now we're beginning to get someplace rather than your somewhat murky explanation of the SEC's position.

Mr. Cox. That was not my intention. It was simply my intention to state that the enforcement program could proceed as it presently has, and I think successfully in prosecuting insider trading on the basis of the law as it currently exists.

Senator D'AMATO. Well, we'll go back again. Could it be improved by this definition?

Mr. Cox. Yes, sir.

Senator D'AMATO. Oh, very good. Let me say this to you so we not detract from the fact that you have kept your commitment and I want to applaud you and the Commission and those of your staff who have made possible the definition that you have submitted, as I said in my opening statement, in a timely manner. I think that's very important. I think that gives us a benchmark by which to begin to compare and to see what areas we have in common—am I out of time?

Senator RIEGLE. Yes.

Senator D'AMATO. All right, Mr. Chairman. I hope we can continue to work with the SEC to draft a workable, plain English definition. Rather than belabor Commissioner Cox and the committee with some rather technical legal questions concerning the SEC's proposed definition, I would suggest that the Commission and the other witnesses work with Committee Counsel Tom Lykos in and address my concerns. Thank you Mr. Chairman.

Senator RIEGLE. Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION
IN SUPPORT OF THE INSIDER TRADING ACT OF 1987

The Securities and Exchange Commission on August 3, 1987 submitted "The Insider Trading Act of 1987," a proposed legislative definition of insider trading. The Commission is pleased to submit to the Subcommittee on Securities of the Senate Banking, Housing and Urban Affairs Committee this memorandum in support of its legislative proposal. The memorandum discusses in general terms the scope and provision of the Insider Trading Act of 1987.

The proposed legislation prohibits insider trading and the tipping of material nonpublic information. It incorporates concepts contained in S. 1380, "The Insider Trading Proscriptions Act of 1987",[1] and concepts that have been considered in the course of other efforts to define insider trading. In addition, the proposed definition reflects the Commission's experience in prosecuting insider trading cases under current law. The Commission believes tha the proposed definition preserves its present authority to take effective action against insider trading, closes certai gaps that may exist in the coverage of current insider tradi law, and provides guidance to securities traders and to securities analysts and other persons who communicate

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[1]S. 1380 was introduced by Senators Reigle and D'Amato June 17, 1987. The bill was prepared by a committee of securities law practitioners chaired by Harvey Pitt, at the request of Senator Riegle.

information about issuers and securities.

Background of the Legislation

As the Commission has stated, "[i]nsider trading in publicly traded securities undermines the expectations of fairness and honesty that underlie public confidence in our nation's securities markets."[2] The Commission further believes that incentives for legitimate information gathering, analysis, and dissemination are essential to the efficient operation of the nation's securities markets.[3] The wrongful obtaining or use of such information is unfair and adversely affects the incentives to invest in such activities.

The Commission is not arguing for or attempting to establish a "parity of information" theory.[4] The Commission agrees that "one may gain an advantage in the market place through conduct constituting skill, foresight, industry and the like. Certainly this is as true in securities law as in antitrust, patent, trademark, copyright and other fields. But one may not gain such advantage by conduct constituting secreting, stealing, purloining or otherwise misappropriating material nonpublic information. . . . Such conduct constitutes chicanery not competition; foul play, not fair

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[2]See Memorandum of the Securities and Exchange Commission in support of the Insider Trading Sanctions Act of 1984, H.R. Rep. No. 355, 99th Cong., 2d Sess. 21 (1984).

[3]See, e.g., Gilson & Kraakman, The Mechanics of Market Efficiency, 70 Va. L. Rev. 549 (1984).

[4]See, Chiarella v. United States, 445 U.S. 222, 233 (1979); Dirks v. SEC, 463 U.S. 646, 657 (1983).

play."[5] The proposed legislative definition of insider trading is intended to distinguish wrongful chicanery from legitimate competition, and to preclude foul play while protecting fair play.

For more than a quarter of a century, the Securities and Exchange Commission has vigorously prosecuted cases involving insider trading, principally under Section 10(b) of the Securities Exchange Act of 1934 and Commission Rule 10b-5 thereunder. To date, the case-by-case development of insider trading law under Section 10(b) has permitted a vigorous Commission enforcement program. The Commission has in recent years brought an increased number of insider trading cases,[6] including many of the largest and most significant cases in the Commission's history.[7]

Recent events demonstrate that insider trading is a serious problem in the securities markets. While the Commission does not believe that a statutory definition is, at

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[5] United States v. Carpenter, 791 F.2d 1024, 1031 (2d Cir. 1986), cert. granted 55 U.S.L.W. 3424 (Dec. 15, 1986).

[6] See Statement of Charles C. Cox, Acting Chairman, Securities and Exchange Commission, before the Subcommittee on Securities of the Senate Banking, Housing and Urban Affairs Committee (June 19, 1987). Since 1981, the Commission has brought 129 insider trading cases, compared to 77 during the prior 47 years; during fiscal 1986, the Commission brought 30 insider trading cases, compared to 20 such cases in 1985. Id. at 4-5.

[7] See, e.g., SEC v. Siegel, No. 87 Civ. 0963 (S.D.N.Y. Feb. 13, 1987); SEC v. Boesky, No. 86 Civ. 8767 (S.D.N.Y. Nov. 14, 1986); SEC v. Levine, No. 86 Civ. 3726 (S.D.N.Y. June 5, 1986).

present, necessary for the continued success of its enforcement program, it recognizes the benefits that can result from an appropriately crafted definition, and appreciates the efforts of the Subcommittee to develop a statutory definition. As reflected in the submission of its legislative proposal, the Commission would support a statutory definition of insider trading that preserves its authority under existing law and provides guidance and flexibility.

"The Insider Trading Act of 1987" is such a definition and has the unanimous support of the Commission. The Commission believes that this proposal provides clarity and guidance, preserves the Commission's authority and flexibility in enforcing the law against insider trading, and enhances the Commission's ability successfully to prosecute insider trading.

Overview of the Proposed Legislation

The proposed legislation adds new Section 16A to the Exchange Act and makes related conforming amendments to that Act. Section 16A expressly prohibits conduct commonly referred to as "insider trading." This legislation builds upon the concepts of breach of duty and misappropriation, which are embodied in the existing law of insider trading. While the legislation does not fundamentally alter the scope of prohibited conduct under present law, it eliminates certain anomalies or ambiguities that have arguably been created by some judicial opinions. The legislation would therefore

contribute to the process of making insider trading law more rational, consistent, and certain.

The proposed legislation generally prohibits any person from buying or selling securities while in possession of material[8] nonpublic information that was "wrongfully" obtained or the use of which would be wrongful. The legislation specifies that information is wrongfully obtained or used if it is obtained by or as a result of, or if its use would constitute, (i) theft, bribery, misrepresentation, or espionage through electronic or other means, or (ii) a breach of a duty to maintain information in confidence, when that duty arises from a relationship with specified sources. The specified sources are issuers, security holders, securities traders, governmental entities, persons registered with the Commission, persons engaged in the business of analyzing and disseminating information concerning securities, and persons who obtain confidential information from such specified sources. The legislation authorizes the Commission to expand the class of specified sources to include others with a regular nexus to the operations of the nation's securities markets.

In addition to prohibiting wrongful trading, the proposed legislation also prohibits any person who cannot lawfully

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[8]A fact is "material" if there is a "substantial likelihood that a reasonable shareholder would consider it important" in making an investment decision about the company's stock. TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

trade from tipping material nonpublic information to others. The proposed legislation imposes direct liability upon a tipper who communicates information that the tipper knows or recklessly disregards is material and nonpublic, to another person who trades, when that trading is reasonably foreseeable. The tipper is also liable if a tippee tips others ("subtippees") who foreseeably trade while in possession of the information.

Under the legislation, a tipper can be liable for the trades of tippees who are not themselves liable. For example, if a tippee neither knows nor recklessly disregards that information was wrongfully conveyed, then the tippee would not violate the statute if he traded while in possession of the information. The tipper may nevertheless be liable for the tippee's trading because of the wrongful tip. Also, the proposed legislation does not require that a person who communicates information be liable in order for the recipient of the information to be prohibited from wrongfully trading while in possession of that information. Thus, if a person communicates material nonpublic information under circumstances in which trading by the recipient is not reasonably foreseeable, the recipient may be liable for his trading (and for tipping) although the person who provides the information is not liable for making the communication.

The proposed legislation also generally codifies existing Commission Rule 14e-3, which prohibits trading by certain

persons possessing material nonpublic information relating to a tender offer. It makes it unlawful for a person other than the tender offeror to trade while in possession of such information if that person knows or recklessly disregards that the information was acquired directly or indirectly from the tender offeror or the target company. The legislation also prohibits (subject to specified exceptions) communicating material nonpublic information relating to a tender offer.

The legislation expressly permits trades or communications by any person authorized to act for the account of another person, if the principal could trade or communicate legally while in possession of the information, as well as communications (but not trades) made in a reasonable effort to make information public. It also protects communications (but not trades) that are made either (a) by a person engaged in the ordinary course of the business of analyzing and disseminating information concerning securities, or (b) to a person engaged in such analysis and dissemination if the communication is not made for the personal benefit of the person making the communication. This latter provision is intended to provide a safe harbor for communications, under specified conditions, by or to securities analysts who further disseminate information to investors in the ordinary course of their business. In addition, the Commission is granted specific authority to exempt any person, security or transaction (or class of persons, securities or transactions)

from the provisions of the legislation, provided that such an exemption is not inconsistent with the purposes of the statute.

A defense to liability is provided to institutions in those situations in which an employee trades on behalf of an institutional account while other employees possesses material nonpublic information. The institution is not liable in such circumstances if the individual making the trade did not know the material nonpublic information, and the institution had implemented procedures, reasonably adequate in the circumstances, to prevent the individual making the investment decision from violating the insider trading rules.

The legislation expressly gives contemporaneous traders the right to recover damages from inside traders or tippers, and expressly provides standing to assert a private right of action to any other person who is injured by a violation in connection with the purchase or sale of a security. The liability of violators to contemporaneous purchasers or sellers is premised on the equitable theory of unjust enrichment, not a concept of harm to contemporaneous traders, and thus is limited to the profit gained or the loss avoided as a result of the violations.

The legislation also would make conforming amendments to the Insider Trading Sanctions Act of 1984 and to Section 20(d) of the Exchange Act.

The Commission is preparing a detailed section-by-section analysis of "The Insider Trading Act of 1987" and will submit this analysis in the near future.

Mr. Cox, you are very familiar, I assume, with the original bill introduced by the chairman of this subcommittee and the Senator from New York, are you not?

Mr. Cox. I am familiar with it.

Senator SHELBY. You've read it, have you not?

Mr. Cox. Yes, sir.

PRESUMPTION OF USE

Senator SHELBY. So you're familiar with that part of it. Do you know that in that bill it had a presumption of use, in other words, a presumption that if someone had certain information in their possession that it would be a presumption that they used this?

Mr. Cox. Yes.

Senator SHELBY. In other words, a presumption of guilt basically.

Mr. Cox. I am familiar with the presumption of use.

Senator SHELBY. Mr. Cox, are you an attorney?

Mr. Cox. No, sir.

Senator SHELBY. Does the Securities and Exchange Commission proposal also contain a use presumption?

Mr. Cox. No, sir.

Senator SHELBY. And why does it not? Because there's a constitutional problem with it?

Mr. Cox. No. I think that we really did it on the basis of clarity, that to say that trading while in possession of material nonpublic information violates the law.

Senator SHELBY. And do you remember the words of the original bill introduced?

Mr. Cox. Not precisely.

Senator SHELBY. Didn't it speak of a presumption?

Mr. Cox. Yes, it said something to the effect that there is a presumption that trading is on the basis of the material nonpublic information.

Senator SHELBY. Who drafted this proposed Securities and Exchange proposal we have?

Mr. Cox. It was a joint effort between the staff of the SEC, mainly the Division of Enforcement, general counsel, and the contributions of the Commissioners.

Senator SHELBY. Did Mr. Pitt or Mr. Olson or any of these eminent attorneys in securities have any input into this?

Mr. Cox. Not directly, but certainly we used S. 1380——

Senator SHELBY. As a starting point?

Mr. Cox. Well, we looked at that, and, I make no bones about it, we built on that.

Senator SHELBY. I have other questions but I think they would probably, Mr. Chairman, be more appropriate for the witnesses that are going to come after this. Thank you.

Senator PROXMIRE. In the absence of the chairman, Senator Shelby, you are chairman of the subcommittee. I think Senator Armstrong is next.

Senator SHELBY. Senator Armstrong.

Senator ARMSTRONG. Thank you, Mr. Chairman. I'm going to withhold for the time being. I thank you.

Senator SHELBY. Senator Proxmire.

Senator PROXMIRE. Would Mr. Lynch, the head of the enforcement division, come forward to the witness table?

Mr. Lynch, in your judgment would S. 1380 put the enforcement division in a weaker or a stronger enforcement position than current law?

Mr. LYNCH. I think it would put us in a stronger position than current law.

Senator PROXMIRE. That's S. 1380?

Mr. LYNCH. That's correct. And certainly the Commission's submission today would put us in a stronger position than current law.

Senator PROXMIRE. That was my second question. Since you've answered that second question, let me ask you if the SEC's recommendation to replace or to modify S. 1380 would strengthen or weaken the situation as compared with S. 1380?

Mr. LYNCH. I think that the Commission's submission is preferable to S. 1380.

Senator PROXMIRE. Why? Where does it strengthen your ability to enforce?

Mr. LYNCH. Well, Acting Chairman Cox has already alluded to this. As S. 1380 was drafted, it raises problems with what we have to establish as to whether the person merely had possession of the information or whether they used that information.

Now I know Mr. Pitt has redrafted certain portions of the proposed statute based on some comments that were made by Senator Shelby at the last hearing that I think go a long way toward solving that particular problem. If those changes are made, then S. 1380 would be even more preferable to the current state of law than it was at the time that it was submitted. But I would still say that even with those changes I think that the Commission's submission is slightly preferable to S. 1380.

Senator SHELBY. I wonder if the chairman would yield?

Senator PROXMIRE. Before I yield, would you submit in writing how you think the SEC recommendation could be strengthened?

Senator SHELBY. Mr. Lynch, you referred to some problems that I had raised in an earlier hearing and those problems as I recall them were basically a constitutional problem I had with the use presumption. Is that what you're alluding to?

Mr. LYNCH. Yes.

Senator SHELBY. And do you believe that you have dealt with some of that in this new proposal?

Mr. LYNCH. I think we have, but to be absolutely clear about this, the way we dealt with it is to say that we don't have to establish that a person used the information. We merely have to establish that the person had possession of the information and they knew or recklessly disregarded that it would be a wrongful use to trade while in possession of that information. So there still would be a state of mind requirement. It wouldn't be sufficient to show that a person merely had the information——

Senator PROXMIRE. But the burden still remains on the prosecution?

Mr. LYNCH. That's correct.

Senator SHELBY. And that would change it from the earlier presumption of possession?

Mr. LYNCH. That's correct.

Senator SHELBY. Thank you.

Mr. COX. We would have to establish that the person possessed it and also show the state of mind.

Senator PROXMIRE. Mr. Chairman, could I reclaim my time?

Senator SHELBY. I thank the chairman for yielding to me.

Senator PROXMIRE. I'd like to ask both you gentlemen, is there any kind of trading on material nonpublic information that could be prosecuted under existing law but that could not be prosecuted under the Commission's proposal?

Mr. COX. I don't think so. I think that what we have done is to be pretty careful to make sure that we've established the same parameters. I spent some time thinking about the cases that we've brought and didn't think of insider trading cases that I'm familiar with that would be excluded by the SEC definition.

Senator PROXMIRE. Is that your answer, too?

Mr. LYNCH. I would agree with that as well. We have analyzed all the cases that we've brought over the last 10 years or so, and there is no case that we have identified that couldn't be brought under this statute.

I should say at this point that there are some hypotheticals attached to the joint written statement of Mr. Pitt, Mr. Levine, and Mr. Olson where they analyze how our proposed statute would work in certain cases. We would disagree with their analysis of how the statute would work. This is probably not the time or place to go through a detailed analysis of hypothetical situations, but I think that's something that could be worked out in the legislative history, clarified if necessary in the statute, so that there would be no mistake about the coverage of the proposed statute.

Senator PROXMIRE. My time is up, Mr. Chairman. Thank you.

Senator RIEGLE. Senator Wirth is next. May I just get one clarification because I want to be sure I heard it right? Did you say in response to Senator Proxmire's question that you thought that either the committee version of the bill or the version that is being proposed by the SEC is preferable to current law? Did I understand you to say that?

Mr. LYNCH. That's correct. I think that either proposed statute would be preferable to current law.

Senator RIEGLE. I'll come back to that. Thank you.

Senator Wirth.

Senator WIRTH. Thank you, Mr. Chairman.

Mr. Cox, let me just start by thanking you for your stewardship in this acting period of time. We haven't always agreed on everything, but I really appreciate the good work that you have done and, again, Mr. Lynch, to add my commendations to the aggressive operation that you all have pursued so well I think in the interest of shareholders overall.

Let me ask you first of all if I might, Mr. Lynch, are there insider trading cases that you would like to have pursued that because there is no specific definition of insider trading you have not been able to pursue?

LACK OF DEFINITION PREVENTS PROSECUTION

Mr. LYNCH. There have been some cases. I think particularly in recent months where we have had a concern as to whether or not we could satisfy the personal benefit test that *Dirks* imposes. To back up a second, under the *Dirks* decision, one has to show that a tipper giving information to a tippee will receive some type of personal benefit, even reputational benefit but some type of personal benefit, by passing that information on to the other person.

That has proved to be somewhat difficult in some cases. The cases still can be pursued perhaps on other theories of violations, but it makes for a more difficult prosecution than it should otherwise be in that circumstance.

Senator WIRTH. So this legislation——

Mr. LYNCH. If I could give an example, I think of the *Tom Reed* case where we brought an action against Mr. Reed and settled it prior to *Dirks*. It was a situation where a father who was on the board of directors of a company——

Senator WIRTH. I remember it well.

Mr. LYNCH [continuing]. Had a conversation with his son. We did allege that in that conversation the father gave information to the son, but it was never our theory that the father gave it to the son for the purpose of the son trading on it.

Now we brought our case and settled the action. Subsequent to *Dirks*, there was a criminal prosecution of that case. The Government really could not argue that the father intended to receive a benefit by giving it to his son because he didn't intend for the son to trade on it, according to the Government's theory. So you had to argue that the son had a confidential relationship with the father such that he breached the relationship with the father by trading. The district court said that one would have to show that there was a regular exchange of business confidences such that there was a legitimate expectation of confidentiality on the part of the father.

Senator WIRTH. Is the personal benefit issue the area of greatest ambiguity to you from the perspective of enforcement?

Mr. LYNCH. The elimination of the personal benefit test is probably one of the biggest advantages that we get out of the statute. In addition, the clarification——

Senator WIRTH. The statute clarifies the father-son relationships?

Mr. LYNCH. No. It simply says that a violation of a personal relationship is sufficient.

Senator WIRTH. Can that be done by the Commission in a regulatory proceeding or does that require legislation?

Mr. LYNCH. I think the far preferable way to do it is through legislation.

Senator WIRTH. Let me ask you, can it be done by the Commission?

Mr. LYNCH. I hate to do this, but that's a question better addressed to our general counsel than to me.

Senator WIRTH. Is your general counsel here?

Mr. LYNCH. He is here.

Senator WIRTH. Can we ask him to come forward? Can we get a yes or no answer?

Mr. GOELZER. Well, if my choices are yes or no, I'll say yes. I think that obviously any rule that we adopted defining insider trading in a way contrary to the case law would undoubtedly be subject to challenge and we would have to litigate the validity of the rule. I do think the Commission has some latitude to define insider trading by rule.

Senator WIRTH. Mr. Cox?

Mr. COX. I guess as to the Commission's authority I'm always greatly persuaded by the general counsel, but the way you phrased the question specifying father-son relationship——

Senator WIRTH. I just said that facetiously.

Mr. COX. All right. I think that the preferable way would be legislative clarification of this issue.

Senator WIRTH. The personal benefit issue?

Mr. COX. Yes, sir.

Senator WIRTH. That would be preferable. But again let me ask the question, can you do it by rule? And the answer to that, I gather, is yes, but any rule can be challenged, right? Any rule can be challenged, as I understand it, and there are a lot of lawyers out there whose time clocks are ticking, looking for opportunities to challenge rules I'm sure, but it can be done by rule?

Mr. COX. Yes.

Senator WIRTH. Mr. Chairman, at some point I think it would be also useful for us to understand what the ramifications of the *Winans* decision may be. I think that as we have these gentlemen up here, that case I understand is being heard in October. I know my time has expired.

Mr. COX. I think that that may be a little early to estimate when there will be a decision.

Senator WIRTH. Well, my time has expired, Mr. Chairman.

Senator RIEGLE. Well, I realize it has, but you posed an important question and they want to respond to it.

Mr. GOELZER. Let me say that the case hasn't been set for argument. The Supreme Court returns for business of course in October, and I assume it will be heard shortly after the Court comes back. The decision is likely to be at least several months after the argument. I would guess the first of the year.

Senator WIRTH. And what are the implications of that for S. 1380, the SEC's proposal, and others?

Mr. GOELZER. Well, I suppose the biggest implication, as Acting Chairman Cox has testified, is that, if the Court were to strike down the misappropriation theory generally in that decision, then we would have a desperate need for legislation in order to continue our program.

If the decision is something other than that, we would have to study the implications of the decision.

Senator WIRTH. Is it assumed that it's likely that the Court will strike it down?

Mr. GOELZER. I don't believe that that's likely.

Senator WIRTH. Is it generally assumed that the *Winans* decision will be such that it puts pressure on us to take steps now on defining insider trading?

Mr. GOELZER. Well, my name is on the Government's brief in the case. I believe that our side is going to prevail in the case. Certain-

ly people have written in law review articles and other publications that they think there's a serious risk in *Winans* that the misappropriation theory will be lost. That's not my view. It is the view of other people.

Senator RIEGLE. Maybe we can come back to that in short order. Senator Armstrong has not taken any time yet and I think has a point he wants to raise here.

COMMUNICATION OF INFORMATION

Senator ARMSTRONG. Mr. Chairman, I don't want to take very much time but I'm troubled by my inability to understand what happens when analysts communicate information to other persons.

I guess we agree under present law and under all pending proposals that a person who is a securities analyst is not passing inside information. He goes to a meeting and learns things about the company and in the due course of business passes it on to the customers of his firm. Or maybe he's a newsletter writer and passes it on. Clearly nobody intends in any way to subject such a person to any liability, but the distinction between that function and somebody who just calls up his neighbor and says, "Boy, I just heard a great report on such and such a company. I'd sure buy a few shares of that," isn't very plain to me.

Maybe I'm just dense about this, but what am I missing here?

Mr. Cox. Well, I certainly don't think that you're dense, Senator Armstrong, but I think that maybe the problem is your example of the person who calls his neighbor. That's why we started from the wrongfulness approach, which asks whether that person has a duty to keep that information in confidence or refrain from trading before he calls his neighbor? Is he the CEO of the corporation who has material nonpublic information and then calls his neighbor to say, "Boy, you really ought to buy some shares of the stock in my company."

Senator ARMSTRONG. But my question is when it becomes public? Clearly, if I'm an analyst or a newsletter writer or a reporter and I put this in my publication—let's say I put it in the morning paper. From the time it appears in the morning paper, I assume that's public information.

Mr. Cox. Yes.

Senator ARMSTRONG. And even the reporter is free to trade in it if he wishes. But the question is, at what point prior to that is he free to do so? Maybe not if he's the only reporter who knows this or one of only a handful who knows it, he's not free to trade in it before the item appears in his newspaper. I guess that's right, isn't it?

Mr. Cox. Well, usually he's under some obligation to the newspaper not to use this information for his own personal benefit but to use it for the benefit of the newspaper.

Senator ARMSTRONG. Well, that's exactly the situation I was getting at and I'm not quite sure—and one reason why I'm not going to pursue this too far this morning is I'm not quite sure whether I'm really addressing a problem that is hypothetical or whether it is a real problem. But conceptually, it's very hard for me to understand exactly when this information passes from the confidential

domain into the public domain. In other words, if the guy who writes for the newspaper writes his story and right after he writes it he trades before it's published, I guess we understand that to be a wrongful trade. Correct?

Mr. Cox. Yes.

Senator ARMSTRONG. What if he is not a newspaper writer but is a newsletter writer and he only sends this newsletter or this analytical report to a group of clients and suppose it's a very small group of clients? Suppose it's not 100,000 people who subscribe to a newspaper, but it's only 100 people or it's only 2 people. That's the distinction I'm trying to be sure I understand but I'm not sure whether I'm really addressing a practical problem or not.

Mr. Cox. OK. I don't think it's a problem. I think that we have attempted in our definition to clarify that—that's why we have the safe harbor for communicating information but not trading with that information. If the person who writes the newsletter and is in the business of gathering information talks to corporate executives and then sends information on to clients, and there may be a few clients or there may be many——

Senator ARMSTRONG. Precisely because he is a communicator rather than a trader?

Mr. Cox. Right. We don't want to inhibit that communication.

Senator ARMSTRONG. Even if he's communicating to a small number of people, even if it's a select clientele?

Mr. Cox. And the communication is in the ordinary course of his business.

Senator ARMSTRONG. Yes. In other words, somebody who writes a stock newsletter or who maybe has a handful of clients with whom he communicates. Are we distinguishing that person from someone who is an investment manager who attends the same meeting?

Mr. Cox. No.

Senator ARMSTRONG. Well, I thought you were saying there was a safe harbor for the person who communicates but not for somebody who is an investment manager or an investor. In other words, if you've got two guys sitting there, one of whom writes for a newsletter—or maybe there's a whole roomful of people, some are newspaper writers and some of them do other things, but also some of the people who are there hearing this information are either individual investors or managers of investment funds for others, are they bound to a different standard than those who are communicators?

Mr. Cox. No, I don't think so. In the example that you presented, if I'm an investor and sitting at a meeting where company executives are telling about the business and then I go away and trade on what I heard at that meeting, that's why the information was being communicated.

Senator ARMSTRONG. So in that case, in essence, the information becomes public when the company executives communicate it to the analysts and writers, not when it is subsequently published?

Mr. Cox. Right. The question of when the company is making the information public doesn't depend on what the individual writer does.

Senator ARMSTRONG. I think that's helpful. I'll think some more about this. I may be just over my head on this. Thank you.

Senator RIEGLE. Let me just clarify one other thing before calling on Senator Sasser, and that relates to this previous conversation before Senator Armstrong spoke. That is, Mr. Goelzer, I understood you to say that if you were to lose the *Winans* case—that you would have a real problem and in fact there would be a gap in the law as you see it and that there would be a rather immediate need for legislation. Is that in effect what you said?

Mr. GOELZER. Well, I would have to say, Senator, that it depends on exactly how the case was lost. If the nature of the loss was for the Supreme Court to reject the misappropriation theory across the board, yes, I think a very serious hole would be opened up in our authority.

Senator RIEGLE. Well, that's precisely the point. And many people have argued that the Congress ought to write the laws and the courts ought to interpret the laws. I don't like seeing us in a situation where, depending upon how the courts make an interpretation in an area that's fuzzy, that we'll wait and see what they decide and then if we find out there's a gap in the law then we'll try to rush in afterward and sort of plug that gap.

Senator D'AMATO. Mr. Chairman, would you yield for just a moment?

Senator RIEGLE. If I may just say, I think our job is to write the law clearly and forcefully ahead of time so that we don't subject people, cases or future events to that kind of sort of judgment by the court that may or may not square with what is needed. That goes right to the heart of why I think we need a clearly written, tightly written law. We should not have to have the future hinge on one or another decision of the court, in my view, not in this area.

Senator D'Amato, you asked me to yield.

Senator D'AMATO. Well, I'm sorry Senator Wirth left because I wanted to pursue if I might very quickly one case which counsel raised which was the *Thomas Reed* case.

From the evidence I review about that case that this subcommittee reviewed, it seemed to me that Reed was trading while in possession of inside information. He called his daddy who was down on a Carribean island about a half a dozen times, he couldn't wait to call his broker. He started at 5 o'clock in the morning, bought options that were running out in 12 days, made $340,000-some-odd in profits, tried to hide it by putting it in other individuals names. His wonderful secretary, her children and others; he said he was doing this as a charitable effort for them. His motives aside, it seems that he was a crook.

Would you have lost that case if you would have one of these two sections of the law there?

Mr. LYNCH. We probably would have lost that case anyway. We didn't lose that case on the law. We got a very favorable opinion out of the district court judge. There were 12 jurors up in Manhattan who decided that he was innocent, who decided that that information was not passed—or at least the Government hadn't proved that beyond a reasonable doubt.

So in fairness to Mr. Reed, he was acquitted on factual grounds. The legal niceties of it had nothing to do with his acquittal.

Senator D'AMATO. It shows you what a New York jury can do sometimes. That's absolutely incredible.

I believe if you have cases where you can't bring them successfully as a result of the absence of a clear definition and have to apply different theories of the law, then we're missing the boat. That's the only statement I have to make. I'm sorry I intruded on your time.

Senator RIEGLE. Thank you, Senator D'Amato.

Senator Sasser.

Senator SASSER. Well, thank you very much, Mr. Chairman. I'm pleased that the Securities Subcommittee today is continuing to examine the issue of a definition of insider trading. It's obviously very complicated. You can judge that by the questions that are being asked here and I can see why we've left the definition of insider trading so long to the courts.

Mr. Cox, let me ask you and your colleagues, on this whole issue of insider trading, what benefits do you believe could be derived from the adoption of new insider trading legislation?

BENEFITS OF INSIDER TRADING DEFINITION

Mr. Cox. I think that the statutory definition would make clear some of the areas that we presently feel are not particularly clear. The way we have phrased our statutory definition, it would be made clear that trading while in possession of material nonpublic information is when the violation occurs.

The second, getting rid of the personal benefit test on tipping. Now it's necessary to show that the tipper had a personal benefit as a result of tipping someone. That showing would no longer be required.

Those are a couple of examples where I think the statutory definition could make a real contribution.

Senator SASSER. Well, I think you may be correct in that analysis. Let me just say that to many of us insider trading basically falls into certain categories and I'd like for you to explain to us—you or your colleagues—just as clearly as you can how the Commission's statutory proposal deals with a number of areas.

First, an individual has information and he or she trades on it. When is that person trading on insider information?

Mr. Cox. Well, certainly we would have to know more than just an individual has information and trades on it.

First, is it material nonpublic information? Second, did that individual acquire it or use it wrongfully? In other words, acquire it by theft, espionage, so forth, or did that individual breach a duty to keep that information in confidence or refrain from trading? That's really the basis of this definition.

Senator SASSER. All right. Let's take another hypothetical. An individual has inside information and he or she does not trade on it themselves but they communicate this information to another person who does trade on it.

Now when is the person who communicates the information to someone else liable under your proposal?

Mr. Cox. The tipper would be liable if he had a duty to keep the material nonpublic information confidential and if there were fore-

seeable trading that would result from communicating this information.

Senator SASSER. So what is the word of art there? Foreseeability? In other words, if the tipper gives the tippee the information and could reasonably foresee that the tippee would use this inside information and trade on it to his advantage, then the tipper would be liable?

Mr. Cox. Yes, sir.

Senator SASSER. All right. Well, how about the person who gets the inside information, the tippee? When do they become liable or do they become liable?

Mr. Cox. Oh, yes.

Senator SASSER. Under what circumstances?

Mr. Cox. When the tippee realizes that this information was obtained in a breach of a duty to keep it confidential and then trades.

Senator SASSER. In other words, if I'm having a cup of coffee with a friend and I have access to information from a brokerage house that I happen to work for that Ajax Cleaning Powder's stock, if purchased is going to go up very rapidly, and I communicate that to the person I'm drinking coffee with, and they know that I'm breaching a duty and they use that information and trade on it to their advantage, they would be liable?

Mr. Cox. Yes. Perhaps you communicated it to the person just because of your personal relationship. You foresaw no trading. You thought that no trading would result. But the friend wasn't the friend that you thought and went out and said, "Look, I know that Senator Sasser had this material nonpublic information with a duty to keep it confidential. Now I've got it. I'm going to trade." In that case, the tippee would be liable for trading.

Senator SASSER. Well, my time has expired, Mr. Chairman. Thank you, Mr. Cox.

Senator RIEGLE. Thank you, Senator Sasser.

We have a panel of three witnesses for which one will speak and then we have a representative from the New York Stock Exchange Legal Advisory Committee. I want to pose just a comment to you. Did you want to go around a second time, Senator Hecht?

Senator HECHT. No. I'm just going to briefly make a couple of statements. I'll take about 1 or 2 minutes.

Senator RIEGLE. Please do that now.

Senator HECHT. Thank you, Mr. Chairman.

I'm just happy I made my opening remarks before all this discussion because I think it clearly shows that we have to be very, very careful which way we go on any type of legislation to unbalance this wheel that's been working so well.

Publicly, I think you, Mr. Cox, have done an excellent job as the acting chairman of the Securities and Exchange Commission during your tenure in that position, and I think publicly I just want to acknowledge that.

Mr. Cox. Thank you very much, Senator Hecht.

Senator RIEGLE. Let me just say now, earlier, Mr. Lynch, when you indicated that the Commission from your vantage point would view our legislative proposal or the one that the SEC is advancing, either one, as preferable to the existing law——

Mr. LYNCH. I didn't say the Commission would say that. I can't speak on behalf of the Commission.

Senator RIEGLE. I understand.

Mr. LYNCH. Certainly I think the Commission believes that its definition is preferable to existing law. I can't speak for the Commission's view on S. 1380.

My own personal view is that S. 1380 would be preferable to the current law because of its clarification of some issues which are in doubt now.

Senator RIEGLE. Well, that's a very important statement and I appreciate it.

Now, Commissioner Cox, would it be the Commission's view that our proposal or your own either would be preferable to the existing state of affairs?

Mr. COX. The Commission hasn't made that decision. They haven't really considered that question. All that I can do is restate what we did consider. The testimony last time is that we couldn't endorse S. 1380 in its present form. But, as you've said and as we've said in our statement, there are more similarities than differences between the two bills, and clearly we unanimously endorse our proposal.

So that's what I can say on behalf of the Commission, sitting as a Commission, about what we endorse.

Senator RIEGLE. I understand. Now you're also a Commissioner, so let me just ask you now for a viewpoint as an individual Commissioner. Let me ask you, not speaking for the Commission but speaking for yourself, are you inclined to agree with the statement that Mr. Lynch just made?

Mr. COX. Yes, Senator.

Senator RIEGLE. I appreciate that.

Finally, before I call on our colleague from Missouri, let me say to you and ask you if the Commission will continue to work with us here? I think your response today within the time limits has been a forthcoming one. I appreciate it. The subcommittee and the full committee appreciates it. And can I assume that it will be the Commission's intention to want to work with us as we see if we can't find a way to reconcile what differences we may have and try to reach a proposal that perhaps we all can support?

Mr. COX. We would be very enthusiastic about your invitation to work with the subcommittee and with Mr. Pitt's group, with Mr. Phillips, and whoever is involved, to assist you in this task.

Senator RIEGLE. I appreciate that because it is a very complex area of law. I think to do it right means that we have to talk, work back and forth. It's sort of a tailoring job of cutting and fitting and cutting and fitting until we get it right, and we want to get it right. And I think we have made a lot of progress. I think we are approaching a point where if everybody proceeds in good faith we can find a common ground that would really be a substantial step forward and serve the public interest. So I appreciate what you've said and the spirit in which you've said it and it is our intention to work with you and the others to try to achieve that goal.

Mr. COX. Thank you.

Senator RIEGLE. Senator Bond.

Senator BOND. Thank you, Mr. Chairman.

From having read the testimony, I wanted to ask Mr. Cox a couple of brief questions and I know that you have touched on this before, but you talked about exempting a person or transaction from provisions of the legislation. Could you give me examples of the kind of exemptions that you might want to grant?

EXEMPTIONS

Mr. Cox. Well, let me say that generally we have that provision there because in such a complex area of the law we really think that it is necessary for the Commission to have the authority to react to a fast-changing securities market. We certainly didn't construct a definition with the idea that there's a lot of people we would have to exempt. We want that exemptive authority for the situation in which we can say, look, to be consistent with what we're setting out to do, here's a situation that legitimately should be exempted.

I don't have a specific example. If we had thought of something specific, I suggest we might have put it in. But I will certainly allow either Mr. Lynch or Mr. Goelzer to speak, if they have an example of the type of situation that should be exempted.

Mr. GOELZER. I agree with your statement, that if we had thought of an area that needed exempting we would have spelled it out in the statute.

Senator BOND. You say you have some major disagreements with S. 1308. What would be the major disagreement? What's the point that the SEC finds most difficult?

Mr. Cox. The most difficult point is that S. 1380 does not make it explicit that trading while in possession of material nonpublic information would constitute a violation.

Senator BOND. Is that the individual or the firm? In other words, you're saying that it is not clear that if an individual had nonpublic information and traded under S. 1380 that that would be a violation?

Mr. Cox. Yes.

Senator BOND. You're not talking about the situation where a multifaceted firm had information?

Mr. Cox. No, because there we rely on the current law, that if the firm has it, the trader does not know that information and if the firm has appropriate procedures——

Senator BOND. A Chinese wall?

Mr. Cox [continuing]. To prevent a violation, then that trading would be allowed under our definition.

Senator BOND. Are there any other things of that magnitude that really are stumbling blocks for you?

Mr. Cox. I don't think so. That was certainly the main stumbling block that would be very important.

Senator BOND. Thank you, Mr. Chairman.

Senator RIEGLE. Thank you, Senator Bond.

Let me thank all three of you for your testimony today and we look forward to working with you. Thank you very much.

Mr. Cox. Thank you, Senator Riegle.

Senator RIEGLE. Let me now call to the table our remaining witnesses this morning. We have a panel of three, Mr. Theodore

Levine, Mr. John Olson, and Mr. Harvey Pitt, and at the same time and not part of this group but representing the New York Stock Exchange Legal Advisory Committee, Mr. Richard Phillips. I'm wondering if Mr. Phillips would also like to come up and be seated at this time. We very much appreciate all of you being here and bringing your thoughts to the subcommittee this morning.

Mr. Pitt, you may begin.

STATEMENT OF HARVEY L. PITT, ESQ.; JOHN F. OLSON, ESQ.; AND THEODORE A. LEVINE, ESQ.

Mr. PITT. Thank you, Mr. Chairman.

We are pleased to be here before you to testify further on S. 1380 and to comment on the proposed revisions to that legislation that have been submitted by the SEC.

In our collective view, the Commission's proposed revisions embrace many of the structural and substantive features of S. 1380 and provide an important contribution to the formulation of effective insider trading legislation.

In view of the time constraints, we have prepared a rather detailed written statement for inclusion in the subcommittee's record and we won't bother to repeat most of those points.

I would like to do two things, if I might, in the brief time available. First, is to call the subcommittee's attention to the fact that we have attached as exhibits to our written statement 2 summary charts that we think may help in ascertaining the approaches of each of the three definitions you have before you. Exhibit D is a summary chart and that's been blown up and is on the wall there from which I would like to make some remarks, and Exhibit E basically sets forth the SEC proposal, S. 1380, and the New York Stock Exchange Legal Advisory Committee. I must say that's only our three interpretations of how those provisions operate.

In addition, I did want to call attention to the fact that in Exhibit I to our written statement we have posited nine hypotheticals that would basically try to compare the SEC proposal and S. 1380. We have done so on a worst case basis, just to see what could be done with some of these things. We recognize that the Commission's interpretation may vary and they have really been designed to point up drafting approaches in line with the chairman's comments of how we can put together something that works.

Let me take a moment if I can to address the areas of both consensus and divergence if I might.

On the chart we basically have—and again, this is Exhibit D in the package. The first major point was congressional findings and I do want to stress there that Congress has consistently been invited by the Supreme Court to state why it deems insider trading to be inappropriate and to codify the law in this area.

I might say that while I respect Mr. Goelzer's position and indeed it might even be that the Government will prevail, I think it is fair to say that most people who are not involved in the case who are impartial observers of the case think that that case will be a loss for the Government. In any event, it certainly does not bode well since Mr. Winans was convicted in both of the lower courts

and the Supreme Court obviously saw something it wanted to challenge.

More importantly I think is the decision that we annexed to our materials, the *Clark* decision, which a judge in the southern district of New York has frozen the prosecution of an alleged coconspirator of Mr. Winans pending the outcome of the misappropriation theory in the Supreme Court.

If applied elsewhere, that could freeze Government prosecutions until the *Winans* case is resolved and that might be until the end of next June. It could be sooner, but it might not be. So for potentially a year, the Government may be saddled with that kind of problem.

The statutory provisions that you have before you all adopt a wrongful use or wrongful obtaining provision. The differences come in the definition of what constitutes wrongful.

S. 1380 basically encompasses and embodies the notion of misappropriation and conversion as well as breaches of duty. The Commission has attempted to be more specific in its delineation of sources of information, but we have found a number of drafting problems in that delineation which may be easily resolved. I think the two approaches can be reconciled but as they stand now they are different.

A third aspect of this is the possession test and there are two reasons to spend some time on that.

POSSESSION TEST

First, as we originally had proposed and as embodied in S. 1380, we made possession the crime based on a presumption. Senator Shelby correctly called to our attention the fact that this would raise significant constitutional questions.

Now while we think that the Government might well prevail in a flat-out constitutional challenge, we recognize the validity of Senator Shelby's comments and we felt that even if we were right, that there wouldn't be holding of unconstitutionality, it was inappropriate to subject legislation that was intended to codify and clarify the law to that possibility. Accordingly, we have suggested a revision that would make it clear that possession is the violation, but then give institutions a mandatory affirmative defense that we think the Supreme Court would uphold and that would obviate the kinds of issues that Senator Shelby correctly raised.

Mr. OLSON. In that regard, the SEC has taken essentially the same approach in their bill as was explained to you, Senator Shelby, a little while ago. So on that point we're in agreement.

Mr. PITT. That brings us in essence to what's number five on our chart, which is the elimination of the Dirks personal benefit test. That has been one of the most troublesome aspects. I don't think I can improve upon Mr. Lynch's statements about how difficult that has been.

I do think, however, that in the discussion of the *Reed* case and the notion that that case went off on the facts, it is fair to state that either S. 1380 or the New York Stock Exchange proposal or the SEC proposal were the law, there might have been a better chance for a conviction.

The judge in *Reed* had to struggle mightily and took 45 or 50 pages to figure out a coherent explication of why the conduct violated a duty to get to the basic principle of law. A clearer principle of law might sway a jury having to deal with difficult facts. That's not to say it would have come out differently or not. It's just to say that I think one can't say the result would have been the same.

Mr. OLSON. If he had to write 50 pages to explain what the law is, you can imagine what his jury instructions were like.

Mr. PITT. The statutory provisions before you all prohibit tipping. There are differences involved. One of the key things, as we indicate in our statement, is that S. 1380 embraces misappropriation and conversion and the SEC proposal eliminates those words. If their intent is to incorporate those concepts, we think that should be put directly in the statute.

The issue of exclusivity is one that all three provisions deal with. In our view, exclusivity should be a matter of statutory compulsion. That is I think a minor drafting technique.

SEC exempting authority the SEC has proposed we think appropriate revisions to S. 1380 and we see no reason to object to what they have proposed.

Finally, I think it's important to deal with two remaining issues. One of the express private remedies. Both the SEC proposal and S. 1380 would recognize an express private right of action and not leave it to implication. The SEC's proposal has a number of technical defects, but the key here is to recognize expressly what the Supreme Court has had to make up through implication all these years and to come up with a sensible theory that serves as a complement to what Congress is attempting to do in the insider trading area.

Finally is the question of analysts, and I might say this is an issue that we have all struggled with. The New York Stock Exchange Advisory Committee was extremely sensitive to this problem. The SEC has been sensitive to it. As we reread S. 1380, there certainly are questions whether we could have done a better job on that particular issue. The Commission's focus on that is constructive.

We are troubled, as Senator Proxmire was, with the exemptions in subsections D(3), (4), and (5), which we think could be drafted differently to avoid a number of potential construction problems that are elucidated by the nine hypotheticals.

On balance, we think that the Commission has marked a welcome turn in the approach toward a statutory definition. They have essentially endorsed the posture that the chairman and Senator D'Amato have taken on this important issue. We support their efforts and we are prepared to do whatever is necessary to assist this subcommittee in putting together a definition that will meet the subcommittee's goals.

Senator RIEGLE. Do either of your companions want to add anything at this point?

Mr. OLSON. I think we are prepared to respond to questions, Senator.

[The complete prepared statement with attachments of Harry Pitt follows:]

JOINT WRITTEN STATEMENT OF HARVEY L. PITT, THEODORE A. LEVINE AND JOHN F. OLSON BEFORE THE SECURITIES SUBCOMMITTEE OF THE SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE REGARDING S. 1380

(August 7, 1987)

EXECUTIVE SUMMARY

The Securities and Exchange Commission (the "SEC" or "Commission") has submitted to the Securities Subcommittee proposed revisions to S. 1380, the Insider Trading Proscriptions Act of 1987 (the "Act"), which was introduced by Senators Donald W. Riegle and Alfonse M. D'Amato on June 17, 1987. The Commission's proposed revisions embrace many of the structural and substantive features of S. 1380, but contain certain significant differences that may require further thought. We briefly summarize below the major points of concurrence and variance between S. 1380 and the Commission proposal:

- The Commission would place the congressional findings in the enacting bill, but not in proposed § 16A, possibly giving rise to ambiguities as to their construction and applicability to the operative prohibitions of § 16A. This result can easily be avoided by including the findings in § 16A, as does S. 1380.

- The Commission's description of information to which the operative prohibitions would apply could exclude certain "market information" cases. The formulation in S. 1380 is decidedly preferable.

- Both approaches look to possession, rather than use, of material, nonpublic information in wrongful trading cases, although the Commission's proposed revision injects certain ambiguities in its formulation that should be avoided.

- The Commission proposal omits the reference contained in S. 1380 to the concepts of "conversion" and "misappropriation" in its definition of what constitutes wrongful use or obtaining of information. This omission could require the development of insider trading jurisprudence anew, with attendant ambiguities, uncertainties and confusion. The Commission's substitution of specified categories of relationships is both too narrow and potentially (through SEC rulemaking) too broad. Criminal liability should be predicated on a more certain and clearly articulated footing.

- Both approaches expressly prohibit "tipping," although the Commission's proposed revision extends tipper liability to the first tier of "sub-tippees." The Commission's approach should be incorporated into S. 1380.

The Commission incorporates exceptions for certain categories of communications that may be so broad as to consume major portions of the proposed prohibitions against wrongful tipping and wrongful trading. These exceptions are inartfully drafted and need to be substantially revised or deleted.

Both approaches create an affirmative defense for firms and other entities, although (i) S. 1380 (but not the SEC proposal) would provide a safe harbor for employers whose only connection to an employee's violation is the mere fact of employment; and (ii) the Commission requires as an element of a firm's affirmative defense proof of procedures to ensure against violations. The Commission's proposals should not be incorporated into S. 1380.

Both proposals provide the Commission with exemptive authority; S. 1380 provides specified types of rulemaking authority, while the Commission would rely on its general rulemaking authority. There would appear to be no policy basis to disagree with the Commission's approach.

- Both proposals authorize a private right of action under § 16A for persons who traded contemporaneously with a violator; the Commission provides for a second type of private action for persons injured otherwise than by contemporaneous trading. The Commission would also not provide any off-set for disgorgement relief. This approach of S. 1380 is preferable.

- Both proposals include a policy statement in a finding that exclusive standards for insider trading cases are desirable and beneficial; S. 1380 contains an operative exclusivity clause providing that S. 1380 shall constitute such an exclusive set of standards. There is a need for a statutory provision respecting exclusivity, but the Commission's approach is superior to that embodied in S. 1380.

* * *

The Commission's proposed revisions provide an important contribution to the formulation of effective insider trading legislation. We look forward to a combined effort to reconcile the few material differences between the two approaches. Now,

more than ever the need for,*/ and the ability to achieve, a statutory definition irrefutable.

*/ There is no doubt about the timeliness of such an effort. On June 30, 1987, Judge Keenan of the Southern District of New York granted the motion of David W. C. Clark, an alleged co-conspirator of former Wall Street Journal reporter R. Foster Winans, for a stay of Clark's indictment pending the Supreme Court's decision in United States v. Carpenter, a decision expected during the first six months of 1988. See United States v. Clark, 87 Cr. 49 (JFK) (June 30, 1987), annexed as Exhibit C. In light of this decision, government prosecutions for insider trading threaten to be delayed for as much as a year.

JOINT WRITTEN STATEMENT OF HARVEY L. PITT, THEODORE A. LEVINE AND JOHN F. OLSON BEFORE THE SECURITIES SUBCOMMITTEE OF THE SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE REGARDING S. 1380

(August 7, 1987)

I. INTRODUCTION

Mr. Chairman, Members of the Subcommittee:

We are pleased to appear before you today to testify further on S. 1380, and to comment on the proposed revisions to that legislation submitted by the Securities and Exchange Commission (the "SEC" or "Commission").[1/]

II. BACKGROUND

On June 17, 1987, Senators Donald W. Riegle and Alfonse M. D'Amato introduced S. 1380, the Insider Trading Proscriptions Act of 1987 (the "Act").[2/] The Act was drafted

1/ Messrs. Pitt, Levine and Olson are members of Fried, Frank, Harris, Shriver & Jacobson, Wilmer, Cutler & Pickering and Gibson, Dunn & Crutcher, respectively, in Washington, D.C. The views we present today are solely our own and do not necessarily represent the views of our respective law firms, or any client of our respective firms.

2/ A copy of S. 1380 is attached hereto as Exhibit A, and a copy of the Commission's Proposal is annexed as Exhibit B.

at this Subcommittee's request by an ad hoc committee of lawyers (the "Legislative Committee") whose mandate was to formulate a precise, plain-English prohibition against insider trading and tipping.[3/]

On June 19, the SEC, through Acting Chairman Charles C. Cox, testified in response to this proposed insider trading legislation. The Commission opined that, although the government could maintain an effective enforcement program without a legislative definition of insider trading, such a definition would be helpful and desirable.[4/] The Commission observed that S. 1380, "in large part, codifies[] existing law,"[5/] but undertook to, and on August 3, 1987 did, submit a revised legislative definition of insider trading.

The Commission's proposal of its own legislative definition of insider trading and related tipping offenses marks a welcome turning point. There now appears to be a

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3/ The process by which the Legislative Committee formulated the Act is detailed in the Hearing Before the Securities Subcomm. of the Senate Banking, Housing and Urban Affairs Comm., 100th Cong., 1st Sess. (June 17, 1987) (Joint Statement of Harvey L. Pitt and John F. Olson) (the "Joint Statement").

4/ Hearings Before the Subcomm. on Securities of the Senate Banking, Housing and Urban Affairs Comm., 100th Cong., 1st Sess. (June 19, 1987) (Testimony of Commissioner Charles C. Cox) (the "Cox Testimony").

5/ Cox Testimony at 6.

consensus that the time has come for a legislative response to insider trading abuses. Given the foundation provided by S. 1380 and the Commission's proposed modifications thereto, we believe that the groundwork has been laid for the prompt enactment of meaningful insider trading legislation.[6/]

III. COMPARISON OF S. 1380 AND THE COMMISSION'S PROPOSAL

We wish to make a few general observations about the draft legislation submitted by the Commission (the "Commission Proposal") before examining the Commission Proposal in detail.[7/]

First, we note that the Commission Proposal retains the general structure of S. 1380. Second, and of greater significance, the Commission Proposal largely adopts many of

6/ There is no doubt about the timeliness of such an effort. On June 30, 1987, Judge Keenan of the Southern District of New York granted the motion of David W. C. Clark, an alleged co-conspirator of former Wall Street Journal reporter R. Foster Winans, for a stay of Clark's indictment pending the Supreme Court's decision in United States v. Carpenter, a decision expected during the first six months of 1988. See United States v. Clark, 87 Cr. 49 (JFK) (June 30, 1987), annexed as Exhibit C. In light of this decision, government prosecutions for insider trading threaten to be delayed for as much as a year.

7/ Given the very short time we have had to analyze the Commission's proposed revisions to S. 1380 (which we received late Monday, August 3rd), there may be additional issues we will call to the Subcommittee's attention over the next two weeks.

the substantive provisions of S. 1380. Thus, although a detailed comparison points up some significant differences between the two approaches, it should be emphasized at the outset that considerable commonality characterizes both efforts, and the Commission Proposal demonstrates the agency's good faith attempt to resolve complex problems that have developed in the evolution of insider trading case law. And, on the points at which the two proposals diverge, we believe the differences can be resolved with little additional effort.

We now would like to turn to the specifics of the Commission Proposal.[8/]

A. CONGRESSIONAL FINDINGS

There are few substantive differences between the statements of purpose contained in S. 1380 as introduced, and as the Commission would modify it. We believe that a prominent, clear statement of Congress's views on this important issue is necessary to enhance the ability of:

- Judges to interpret and apply the statute;

8/ For the Subcommittee's convenience, we have annexed two summary charts. The first (Exhibit D) summarizes the major points of convergence and divergence between S. 1380 and the Commission's Proposal. The second (Exhibit E) summarizes the principal provisions of S. 1380, the Commission's Proposal and the proposal of the New York Stock Exchange's Legal Advisory Committee.

- Government agencies to establish enforcement goals and policies;
- Lawyers to counsel clients to avoid running afoul of the prohibitions; and
- Honest people wishing to comply with the law to comprehend its scope and application.

Although a procedural point, it is significant to note that the Commission would place the proposed findings in the enacting bill, but not in that portion of the legislation that would become part of the Securities Exchange Act. In our view, this will create difficulties in the application and construction of these findings that could be avoided by their inclusion in Section 16A. We do not believe our approach would create any difficulties for the Commission.

Unlike S. 1380, however, which addresses "material, nonpublic information relating to a particular security or group of securities (or the market for such security or group of securities),"[9/] the Commission's findings would only recognize the category of "material, nonpublic information relating to an issuer or its securities."[10/] This narrower category of information may exclude certain market

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9/ S. 1380, § 16A(a)(1).

10/ SEC Section 2(1). The same class of relevant information appears in the Commission Proposal's operative prohibition against wrongful trading. See SEC § 16A(a).

information" cases, where the subject of the material, nonpublic information is neither a public company nor its securities but, rather, is the market for a particular security or group of securities.

A simple hypothetical deomonstrates this possible difference. Assume X, an employee of a law firm handling the arrangements for the liquidation of A Corporation, a major supplier of widgets, converted that information to his personal use and purchased securities of B, C and D Companies, his client's (X's) competitors, anticipating that their market shares will increase dramatically when A terminates business, to be followed by a commensurate increase in the market price of their stock. X's transactions might fall beyond the reach of the proscription in the Commission Proposal, since the information employed related neither to the competitor as to which X had inside information, nor its securities. X's transactions would unquestionably be illegal under the law today, and under S. 1380.

The Commission's findings assert that, in addition to the fairness and integrity of the capital markets, market efficiency is also adversely affected by insider trading, thereby refuting the notion advocated by certain individuals that insider trading advances market efficiency and

consequently outweighs its resulting harm.[11/] We believe the Commission's change is a salutary one.

The Commission Proposal sets forth in its findings[12/] a statement of the jurisdictional-means language than is found in the various provisions of the federal securities laws to reflect Congress' exercise of its interstate commerce and mail powers.[13/] This articulation is, however, narrower than that set forth in (1) S. 1380,[14/] (2) current statutory law, and (3) applicable judicial decisions. It is imperative that the jurisdictional-means language be set forth in the statute itself, as S. 1380 and present law provide, and sufficiently broadly to avoid any ambiguity in the coverage of the statute.

Another major issue addressed by both S. 1380 and the SEC is the need to make any legislation the exclusive set of standards by which to address and assess allegations of insider trading. Although the Commission's proposal references

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11/ See Hearings Before the Subcomm. on Securities of the Senate Banking, Housing and Urban Affairs Comm., 100th Cong., 1st Sess. (June 17, 1987) (Statement of Henry G. Manne).

12/ See Section 2(2).

13/ See, e.g., 15 U.S.C. § 78j (1982) ("It shall be unlawful for any person * * * by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange * * *").

14/ S. 1380, § 16A(b)(1).

exclusivity in the findings portion of its proposal, rather than in the statute itself, and nowhere states that proposed Section 16A actually provides such exclusive standards.[15/] the SEC's formulation provides a more workable basis for such a statutory provision than is currently contained in S. 1380.

B. WRONGFUL TRADING PROSCRIPTIONS

On July 13, 1987, we submitted to the Securities Subcommittee a revised formulation of S. 1380, Section 16A(b), in response to a discussion of a legal issue raised by Senator Richard C. Shelby during hearings before the Subcommittee on June 17, 1987.[16/] As revised, S. 1380 defines the offense of insider trading, as does the SEC Proposal, as a transaction in a security while in possession of material, nonpublic information concerning the subject security if such information has been used or obtained wrongfully, whether knowingly or

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15/ See SEC Section 2(4).

16/ Senator Shelby expressed concern as to whether the use of a presumption in the Act would implicate constitutional questions in cases in which a criminal conviction resulted from application of the presumption. Although we believe that the statute would withstand a constitutional challenge, a revised Section 16A(b) was submitted, in an effort to avoid the potential ambiguity that could flow from such a challenge. A copy of the memorandum embodying our view and revised statutory language are attached hereto as Exhibit F.

recklessly. Both proposals obviate the need to prove that the material, nonpublic information wrongfully was used in connection with a securities transaction.

The Commission, however, would inject certain troublesome concepts into this wrongful trading prohibition. First, the Commission Proposal would proscribe "caus[ing] the purchase or sale of, any security while in possession of material, nonpublic information * * *."[17/] This proscribed conduct either is superfluous, for it seems to address indirect trading (which is already expressly proscribed), or is susceptible of unpredictable application to conduct that is neither direct nor indirect trading.

For example, under the SEC's Proposal, one could allege that a broker-dealer that has maintained inadequate supervisory procedures "caused" violative trading undertaken by an employee for the employee's own benefit. Since the firm's inadequate supervisory procedures would be subject to separate disciplinary sanctions under existing law, it would be manifestly unfair to charge the firm with insider trading violations and subject the firm to the potential of treble damages therefor.

17/ SEC § 16A(a).

The Commission's Proposal also would expand the definition of "wrongfulness" to reach information "obtained by or as a result of" the enumerated types of conduct that follow.[18/] This provision appears to eliminate any requirement of a culpable mental state from the elements of proof of tippee liability. A person trading in good faith with no indicia that his information emanated from a wrongful source would nevertheless be liable if it were later shown that his information had been wrongfully obtained or communicated by some other person. The Commission could not have intended this result, but its language is susceptible of such an interpretation.

S. 1380 takes a more direct approach to the definition of "wrongful" trading, combining the concept of "misappropriation" with certain aspects of the breach-of-duty analysis that have emerged from insider trading case law.[19/] Thus, under S. 1380, information is wrongfully used or obtained

> "only if it has been obtained by, or its use would constitute, directly or indirectly, theft, conversion,

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18/ SEC § 16A(a)(2).

19/ See Joint Statement at 5-6; see also Pitt, H. & Shapiro, K., New Act May Help Clarify Law, N.Y.L.J., July 27, 1987; Pitt, H., Olson, J. & Shapiro, K., 1987 Insider Trading Proscriptions Act, N.Y.L.J., June 25, 1987, attached hereto as Exhibits G and H, respectively.

> misappropriation or a breach of any fiduciary, contractual, employment, personal or other relationship of trust and confidence."[20/]

Surprisingly, the Commission's Proposal would omit from the definition of wrongful trading any reference to the misappropriation or conversion, the sine qua non of the insider trading enforcement program in the post-Dirks/Chiarella era. This is unfortunate, because (i) the term "misappropriation" has been painstakingly developed by the courts and the Commission in numerous cases over the past several years,[21/] (ii) the omission of that concept would possibly preclude certain cases that should be brought, (iii) the omission of that concept might require the development of a new body of law with its concomitmant uncertainties; and (iv) this formulation would substitute SEC rulemaking for clearly-defined standards applicable to criminal prosecutions, an untenable state of the law.

20/ See S. 1380, § 16A(b)(1).

21/ See, e.g., United States v. Carpenter, 791 F.2d 1024 (2d Cir.), cert. granted, 107 S. Ct. 666 (1986); Securities & Exchange Comm'n v. Materia, 745 F.2d 197 (2d Cir. 1984); United States v. Newman, 664 F.2d 12 (2d Cir. 1981), cert. denied, 464 U.S. 863 (1983); Securities & Exchange Comm'n v. Tome, 638 F. Supp. 596 (S.D.N.Y. 1986), later proceeding, No. 81-C-1836 (MP) (S.D.N.Y. Apr. 3, 1987).

We find this omission to be particularly troublesome in view of Commissioner Cox's recent testimony before this Subcommittee, that, if the Supreme Court "threw out the misappropriation theory [that] would make a statute absolutely necessary for the kinds of cases that the SEC has been bringing."[22/] We firmly oppose the exclusion of the misappropriation concept.

The Commission's Proposal then enumerates types of relationships that may give rise to two duties of unspecified origin: a duty to preserve the confidentiality of information and a duty to refrain from trading. The provision lists four specific classes of persons with whom such a relationship may exist, but then adds two "catch-all" categories of as-yet undefined persons. This formulation, in our view, is inartfully drafted, would at best engender great confusion and uncertainty, and at worst might seriously impair the effectiveness of the Commission's enforcement efforts, as demonstrated by the hypotheticals we have annexed to this statement.[23/]

22/ Transcript of Hearings Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, 100th Cong., 1st Sess. 36 (June 19, 1987) (Testimony of Commissioner Charles C. Cox).

23/ These hypotheticals are annexed as Exhibit I.

The Commission's Proposal also sets out a specific wrongful trading provision designed to address the misuse of material, nonpublic information in the context of tender offers.[24/] This provision is almost identical in format and content to portions of the prohibition of SEC Rule 14e-3.[25/] The wholesale adoption of this Rule is not, in our view, an adequate substitute for the scope and clarity of S. 1380.

C. WRONGFUL COMMUNICATION PROSCRIPTIONS

S. 1380 and the Commission Proposal each contain general and specific anti-tipping provisions.

The general anti-tipping provision contained in S. 1380 proscribes the wrongful communication of material, nonpublic information about a security if the communicator knows or recklessly disregards the fact that the information communicated would be used for a wrongful trade. The specific anti-tipping provision of S. 1380 would prevent the practice of "tipping" material, nonpublic information to market professionals by any person contemplating any extraordinary corporate transaction involving a public company, for the

24/ SEC § 16A(c).

25/ 17 CFR §240.14e-3 (1986).

purpose of influencing or encouraging transactions in the affected securities.[26/]

The general anti-tipping provision in the Commission Proposal prohibits the communication of information, known or recklessly disregarded to be material and nonpublic, to any person who either trades the affected security or communicates the information to another person who trades the affected security.[27/] The Commission's formulation of tipper liability reaches beyond communications to direct tippees and extends to subsequent communications by tippees to first-generation remote tippees, where such "sub-tips" lead to trades that reasonably could have been foreseen by the original tipper. We believe this is an improvement over the formulation of tipper liability in S. 1380.

26/ Section 16A(c)(2) of the Act addresses its prohibition to

> "any person planning an acquisition or disposition of an issuer, a material block of the issuer's securities or its assets, or any person acting on behalf of such a person * * *."

27/ We surmise that, despite the absence of appropriate language to that effect, the Commission Proposal intends that the information that is the subject of such communications bear some relationship to the security traded, its issuer or the market for the security in question.

The anti-tipping prohibitions in the Commission's Proposal do not address certain types of abusive conduct -- for example, the tipping by stock accumulators to arbitraguers of material nonpublic information concerning proposed extraordinary corporate transactions or stock accumulations. Moreover, the Commission's proposal contains rather broadly-worded provisions that would protect otherwise unlawful communications from the anti-tipping prohibition. Those provisions could leave substantial gaps in the statutory coverage that the Commission surely does not intend.

D. DERIVATIVE LIABILITY OF EMPLOYERS AND CONTROLLING PERSONS

The standards for secondary liability set forth in S. 1380 and the Commission Proposal are similar, although they contain certain notable differences.

S. 1380 first establishes a threshold showing that must be established before the merits of secondary liability can be considered. It first must be shown that some basis other than the mere fact of employment or control of the violator warrants reaching a merits-based assessment of the employer's or controlling person's conduct.[28/] If such person neither participated in nor directly or indirectly induced the violation, then the sole fact of the employment or control

28/ See S. 1380, § 16A(d).

relationship will not suffice as a predicate for secondary liability.[29/]

If, however, additional relevant facts are shown, such as profit to the employer resulting from, or some other participation by the employer in, the employee's violation, then the entity employing or controlling the violator will have to show that: (i) the trade was not influenced by the information; and (ii) the person effecting or causing the trade did not know the information.[30/] The implementation and maintenance of reasonable procedures designed to prevent violations are relevant to the determination whether the entity has sustained this burden of proof.[31/]

The Commission Proposal would not incorporate a requirement of a prima facie showing of participation or inducement comparable to that contained in Section 16A(d) of S. 1380; rather, the standards proposed by the Commission (borrowed from Rule 14e-3(b)) base exemption from liability exclusively on a showing that: (i) the person effecting or causing the trade did not know the information in question; and

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29/ Id.

30/ It should be noted that this exception is available only to entities. Id.

31/ Indeed, an entity would be hard-pressed to sustain its burden of proof without demonstrating the existence of such procedures.

(ii) the entity implemented reasonable procedures to ensure that employees making investment decisions do not violate the Act. The Commission Proposal specifically identifies restricted lists and Chinese Walls as approved procedures within the meaning of this provision. Presumably, however, procedures that ensure that employees would not violate insider trading proscriptions would be difficult to show in a case where a violation has nevertheless occurred.

Beyond these considerations, however, we are more seriously troubled by the elevation of procedures to an element of an issuer's affirmative defense to insider trading liability for what, in many if not most cases, will be based on the wrongful acts of an employee. Persons found guilty of violations of this statute will be subject to the treble damages provisions of the Insider Trading Sanctions Act of 1984 ("ITSA").[32/] Under the standards set out in the Commission Proposal, a firm could be liable for disgorgement plus a treble civil fine if:

(i) an employee, off on a frolic of his own;

(ii) effects violative trades;

(iii) through an account at another firm;

32/ 15 U.S.C. § 78u(d)(2)(A) (Supp. 1984).

(iv) without reporting either the account or the trades to his employer;

(v) in spite of the firm's clear requirement that he not maintain any outside account;

(vi) if in a completely unrelated instance involving no allegation of a violation of the law;

(vii) it comes out in the course of the trial that a supervisory procedure implemented by the firm did not ensure against violations.

This seems to us to be an unintended result but could follow as a result of any absolute requirement of reasonable procedures in a treble damages statute.

In our view, the Commission has ample authority under current law to proceed against firms with inadequate supervisory and compliance procedures. The Commission currently can discipline regulated persons in administrative proceedings for their failure to supervise.[33/] It cannot be gainsaid that employers must be held accountable for failure adequately to supervise their employees. Since the current regulatory scheme provides a formidable array of mechanisms by which to achieve that goal, S. 1380 does not seek to alter that legal framework.

33/ See 15 U.S.C. § 15(b)(4)(E)(1982).

At the same time, it must be clear that the mere fact of employment of a violator, without more, should not suffice to expose the employer to treble civil penalties. As the example above underscores, even the best procedures can be circumvented by a person determined to evade their strictures. To expose firms to treble penalties in such cases is unfair and, more significantly, bears no relationship to the goal of reducing such misconduct. Indeed, firms already have every incentive to rid themselves of venal employees, and to avoid the collateral loss of goodwill (and customers) that accompanies revelations of such misdeeds.

E. COMMISSION RULEMAKING AUTHORITY

In view of the carefully tailored, precise framework of regulation set out in the operative provisions of S. 1380, we determined that the general rulemaking authority granted to the Commission under the Securities Exchange Act would be inapposite.[34/] Rather, a specific rulemaking provision was tailored to meet the goals of S. 1380 in two ways. The provision: (i) authorizes the Commission to "implement" the provisions of the Act, consistent with the policies embodied in the congressional findings; and (ii) delegates to the Commission exemptive authority as to persons, securities,

34/ See Joint Statement at 36.

transactions, or any class or classes thereof, consistent with the intended reach of the Act.[35/]

The Commission Proposal seems tacitly to rely on the agency's general rulemaking authority, and specifically addresses itself to an affirmative grant of exemptive authority where the exemptions granted are not inconsistent with the purposes of the Act.[36/]

The apparent difference between the two formulations of Commission rulemaking authority may simply boil down to a question of semantics, as "implementation" probably encompasses a fairly wide range of activities, and the Commission's current rulemaking authority is not likely ever to be construed as enabling the agency to adopt rules inconsistent with the polices underlying the Exchange Act. Thus, the Commission's approach to the issue of rulemaking authority is, in our view, an acceptable alternative to S. 1380.

F. PRIVATE RIGHT OF ACTION

The express private remedy provided in S. 1380, while not precluding other forms of private suits, was designed to assure that the most readily ascertainable class of plaintiffs -- that is, those persons who traded the affected securities in the

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35/ See S. 1380, § 16A(e).

36/ See SEC § 16A(d)(1).

same market as the alleged insider trader -- would be assured, as intended beneficiaries of the Act, of a means by which to avail themselves of the benefits of such protection.[37/] The provision also: (i) limits the amount of any damages awarded to the alleged violator's profits gained or losses avoided; (ii) provides that, in those instances in which the Commission has already brought an action against the defendant based on the same facts and he has disgorged his ill-gotten gains into a fund, any civil damages shall be diminished by, and recovered from, such fund; (iii) establishes joint and several liability on the part of tippers whose tips lead to the trades giving rise to the action; and (iv) incorporates the five-year statute of limitations set forth in ITSA.

The Commission Proposal would authorize two classes of private plaintiffs to pursue claims for injuries sustained as a result of violations of the insider trading and tipping prohibitions.[38/] The framework outlined by the Commission provides a remedy for persons trading contemporaneously with the alleged insider trader, with the same limitation on damages and statute of limitations authorized in § 1380.[39/] The

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37/ See Joint Statement at 37.

38/ See SEC § 16A(e).

39/ Id.

EXHIBIT B

A BILL

To amend the Securities Exchange Act of 1934.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled.

SECTION 1. SHORT TITLE.

This Act may be cited as "The Insider Trading Act of 1987."

SECTION 2. FINDINGS.

(1) The fairness, efficiency and integrity of the nation's securities markets are impaired when corporate insiders or other persons who obtain material nonpublic information relating to an issuer or its securities wrongfully trade, or wrongfully cause the trading of, securities while in possession of that information, or wrongfully communicate that information to others who misuse it in connection with the purchase or sale of any security.

(2) The wrongful trading of securities is carried on to a substantial extent in interstate and foreign commerce, and through the means and instrumentalities of such commerce. Even when wrongful trading while in possession of material nonpublic information and wrongful communication of such information are primarily intrastate in character, these activities nonetheless have a direct effect on interstate and foreign commerce. Effective prohibitions against such wrongful trading and communication are necessary to preserve the integrity of the nation's markets and their ability to serve important domestic and international economic functions, including capital formation.

(3) There is an important public interest in the prompt flow of information to the securities markets.

(4) It is appropriate to establish exclusive statutory prohibitions that clarify what conduct constitutes such wrongful trading and communication, and thereby reduce uncertainties in the state of the law without otherwise affecting existing statutory prohibitions against other manipulative, deceptive or fraudulent conduct.

SECTION 3. INSIDER TRADING PROSCRIPTIONS.

Chapter 78 of title 15, United States Code, is amended, by adding at the end of § 78p the following new section:

Section 16A. PROHIBITION AGAINST TRADING WHILE IN POSSESSION OF, AND COMMUNICATING, MATERIAL NONPUBLIC INFORMATION

(a) It shall be unlawful for any person, directly or indirectly, to purchase, sell, or cause the purchase or sale of, any security while in possession of material nonpublic information concerning the issuer or its securities, if such person knows or recklessly disregards that such information has been obtained wrongfully or that such purchase or sale would constitute a wrongful use of such information. For purposes of this Section, information is obtained or used wrongfully if, directly or indirectly, it has been obtained by or as a result of, or its use would constitute:

(1) theft, bribery, misrepresentation, or espionage through electronic or other means; or

(2) a breach of a duty to maintain such information in confidence or to refrain from purchasing, selling, or causing the purchase or sale of, the security, which duty arises from any fiduciary, contractual, employment, personal or other relationship with:

(A) the issuer of the security or its securityholders,

(B) any person planning or engaged in an acquisition or disposition of the issuer's securities or assets,

(C) any government, or a political subdivision, agency or instrumentality of a government,

(D) any person, or any self-regulatory organization, registered or required to be registered with the Commission under any provision of the federal securities laws (as that term is defined in Section 21(g) of this title),

(E) any person engaged in the business of gathering, analyzing, or disseminating information concerning securities, the markets for securities, or the financial condition of issuers,

(F) any other person that is a member of a class that the Commission designates, by rule or regulation, where the Commission finds (i) that the activities of the members of such class have a regular nexus to the operation of the nation's securities markets, and (ii) that such designation is necessary or appropriate to effectuate the purposes of this Section, or

(G) any other person who obtained such information as a result of a direct or indirect confidential relationship with any of the persons or entities referred to in paragraphs (A)-(F) above.

(b) It shall be unlawful for any person, whose purchase or sale of a security would violate subsection (a) of this Section, to communicate, directly or indirectly, information that such person knows or recklessly disregards is material and nonpublic to any other person who, directly or indirectly, purchases, sells, or causes the purchase or sale of, such security or who communicates the information to another person who makes or causes such a purchase or sale, if such purchase or sale is reasonably foreseeable.

(c) (1) If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the "offering person"), it shall be unlawful for any other person who is in possession of material nonpublic information relating to such tender offer, which information such other person knows or recklessly disregards has been acquired directly or indirectly from (i) the offering person, (ii) the issuer of the securities sought or to be sought by such tender offer, or (iii) any officer, director, partner or employee or any other person acting on behalf of the offering person or such issuer, to purchase or sell or cause to be purchased or sold any security of such issuer, except for sales to the offering person.

(2) (A) It shall be unlawful for any person described in paragraph (2)(B) of this subsection (c) to communicate, directly or indirectly, material nonpublic information relating to a tender offer to any other person under circumstances in which it is reasonably foreseeable that such communication is likely to result in a violation of

Commission, however, casts this remedy in terms of absolute liability (and guaranteed recovery) once a violation is shown,[40/] thus eliminating the need for plaintiffs to prove causation, reliance, or even any compensable injury arising from the violation. The SEC's Proposal also could potentially affect adversely the agency's ability to settle related administrative proceedings. The SEC's propusal does not contain any off-set for penalties disgorged in a Commission proceeding. We believe such a provision is a necessary attribute of any private remedy provision.

Our Legislative Committee considered, and rejected, the inclusion in S. 1380 of a provision similar to that in the Commission's second private action provision. We thought it appropriate that such claims rely on any remedy that may exist under state law rather than the federal securities laws, although S. 1380 would not preclude a court from implying such relief if an injury arising from an insider trading violation is shown.

G. EXCLUSIVITY

While both proposed statutes recognize that exclusive standards should be applied in insider trading cases, the two bills differ in the structural and substantive treatment of

40/ See SEC § 16A(e)(1).

this critically important issue. S. 1380 both addresses the policy reasons for creating an exclusive set of standards in insider trading cases,[41/] and includes an operative provision establishing that the framework of Section 16A shall provide those exclusive standards.[42/]

The Commission Proposal, by contrast, acknowledges the 'appropriateness' of establishing exclusive statutory prohibitions against the offenses of insider trading and tipping, but, as discussed above, places that view in a congressional finding that would not become part of the Exchange Act,[43/] nowhere in what would become the new Section 16A is there any indication that the standards set forth therein would in fact provide the exclusive framework for insider trading cases.

H TECHNICAL AMENDMENTS TO THE EXCHANGE ACT PROPOSED BY THE COMMISSION

The Commission, in its draft statute, also proposed several minor technical amendments to the Exchange Act. These modifications would conform certain sections of the Exchange Act to the new provisions of the Commission's proposed Section

41/ See S. 1380, § 16(A)(a)(4).

42/ See S. 1380, § 16A(g).

43/ See SEC Section 2.

16A.[44/] In brief, these provisions would amend ITSA to reach tipping, as well as trading, cases and to embrace the concept of exclusivity; amend Section 21(d)(2)(B) of the Exchange Act[45/] to preclude application of ITSA's treble civil fine to aiding and abetting cases; and extend the reach of Section 20(d) of the Exchange Act[46/] (which currently applies the insider trading and tipping prohibitions to transactions in puts, calls, straddles, options and similar instruments) to embrace the conduct of persons who cause such transactions. This amendment would also expand the class of securities to which the section applies, to include bonds, notes, debentures, and other debt instruments in cases when the information in question is material to such instrument.[47/] These changes all seem appropriate to us.

CONCLUSION

In our view, the SEC has made a constructive and important contribution to the final formulation of meaningful

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44/ See SEC Sections 4 & 5.

45/ 15 U.S.C. § 78u(d)(2)(B)(Supp. 1984).

46/ 15 U.S.C. § 78t(d) (Supp. 1984).

47/ The Commission Proposal would also remove this amended provision from the "Liability of Controlling Persons" section and add it to the end of the Commission's proposed Section 16A, placing with the principal insider trading prohibitions.

insider trading legislation. We are more confident than ever that a workable, plain-English definition of the offense of insider trading is within reach. We look forward to working with the Commission and this Subcommittee to reconcile the few material differences in approach.

100TH CONGRESS
1ST SESSION

S. 1380

To amend the Securities Exchange Act of 1934 to prohibit certain trading or communications by those who possess material, nonpublic information.

IN THE SENATE OF THE UNITED STATES

JUNE 17, 1987

Mr. RIEGLE (for himself and Mr. D'AMATO) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

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A BILL

To amend the Securities Exchange Act of 1934 to prohibit certain trading or communications by those who possess material, nonpublic information.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Insider Trading Proscriptions Act of 1987".

SEC. 2. INSIDER TRADING PROSCRIPTIONS.

Chapter 78 of title 15, United States Code, is amended, by adding at the end of section 78p the following:

"§ 16A.

"(a) FINDINGS.—

"(1) The fairness, honesty, and integrity of the Nation's securities markets are impaired when corporate insiders and other persons who obtain material, nonpublic information relating to a particular security or group of securities (or the market for such security or group of securities) wrongfully use that information, or wrongfully communicate that information to others who misuse it, in connection with the purchase or sale of any security.

"(2) Effective prohibitions against trading by persons who wrongfully use material, nonpublic information, and wrongfully communicate that information to others who misuse it, are necessary to preserve the integrity of our markets and their ability to serve important national and international economic functions, including capital formation.

"(3) There is an important public interest in the prompt, unfettered flow to the securities markets of information.

"(4) The specific delineation of what constitutes the wrongful use or wrongful communication of material, nonpublic information provided herein is necessary to promote greater clarity in the law.

"(b) PROHIBITION AGAINST THE USE OF MATERIAL, NONPUBLIC INFORMATION.—

"(1) It shall be unlawful for any person, directly or indirectly, to use material, nonpublic information to purchase or sell any security, by the use of any means or instrumentalities of interstate commerce, or of the mails, or of any facilities of any national securities exchange, or of any automated quotations system maintained for the trading of securities, if such person knows or is reckless in not knowing that such information has been obtained wrongfully, or if the purchase or sale of such security would constitute a wrongful use of such information. For the purposes of this section, information shall have been used or obtained wrongfully only if it has been obtained by, or its use would constitute, directly or indirectly, theft, conversion, misappropriation or a breach of any fiduciary, contractual, employment, personal or other relationship of trust and confidence.

"(2) For purposes of subsection (b)(1), any person who purchases or sells a security while in possession of material, nonpublic information relating to that security (or the market therefor) shall be presumed to have used that information in connection with such purchase or sale. Notwithstanding the foregoing, in the case of a

person other than a natural person, the presumption that such material, nonpublic information in that person's possession was used in connection with transactions in that security shall be overcome if such person sustains the burden of proving that—

"(A) the purchase or sale of the security was not influenced by such material, nonpublic information; and

"(B) the individual effecting the purchase or sale, or causing others to purchase or sell, on behalf of such person, did not know the material, nonpublic information.

In determining whether any person other than a natural person has sustained its burden of proof under this subsection, it shall be relevant whether, and to what extent, such person has implemented and maintained reasonable policies and procedures to prevent violations of this section by the individuals making or influencing investment decisions on its behalf.

"(c) PROHIBITIONS AGAINST THE WRONGFUL COMMUNICATION OF CERTAIN MATERIAL, NONPUBLIC INFORMATION.—

"(1) It shall be unlawful for any person, directly or indirectly, wrongfully to communicate material, nonpublic information to another person who, directly or

indirectly, purchases or sells any security that is directly or indirectly the subject of the communication, while in possession of such information, if the person making the communication knows (or is reckless in not knowing) that such information would be used for a purchase or sale of a security that would violate subsection (b) of this section.

"(2) It shall be unlawful for any person planning an acquisition or disposition of an issuer, a material block of the issuer's securities or its assets, or any person acting on behalf of such a person (herein the 'transacting person'), for the purpose of influencing or encouraging the purchase or sale of the securities of such issuer, to communicate, directly or indirectly, material, nonpublic information concerning such plans to any other person who thereafter purchases or sells the affected securities, unless such other person is acting on behalf of or as part of a group with the transacting person (within the meaning of section 13(d)(3) of this title) or the communication of such information has been made in the course of a good faith solicitation of such other person to act on behalf of or as part of a group with the transacting person (within the meaning of section 13(d)(3) of this title) or the securities are ac-

quired directly from or sold directly to the transacting person.

"(d) DERIVATIVE LIABILITY.—No person shall be liable under this section solely by reason of the fact that such person controls or employes a person who has violated this section, if such controlling person or employer neither participated in, nor directly or indirectly induced the acts constituting the violation of this section.

"(e) COMMISSION RULEMAKING AND ORDERS.—The Commission may, by rules consistent with the provisions of this section, implement the provisions of this section. The Commission, by rules, or by order, may exempt any person, security or transaction, or any class or classes of persons, securities or transactions, from any provision or provisions of this section, if and to the extent that such exemption is consistent with the provisions of this section.

"(f) PRIVATE RIGHTS OF ACTION.—Any person who is injured by a violation of this section in connection with the purchase or sale of any security may recover any damages sustained by reason of such violation. For the purpose of this section, a person shall be deemed to have been injured by a violation of this section if such person has purchased or sold the affected securities contemporaneously with the transactions in such securities that form the basis of the violation of paragraph (b) or (c) of this section. No person shall be liable

in damages in any action under this subsection for an amount in excess of such person's actual profit obtained or loss avoided. Any damages imposed against any person under this subsection shall be diminished by (and, where available, recovered from) the amounts, if any, that such person may be required to disgorge, pursuant to a court order obtained at the instance of the Commission, in a proceeding brought under section 21(d) of this title relating to the same transaction or transactions. Any person who violates subsection (c) of this section shall be liable, jointly and severally, to the same extent as any persons who obtained profits or avoided losses as a result of such violations of subsection (c). The period of limitations for the commencement of any action under this subsection shall be the same as that provided in section 21(d)(2)(D) of this title (the Insider Trading Sanctions Act).

"(g) EXCLUSIVITY.—This section shall provide the exclusive standards by which the wrongful use or wrongful communication of material, nonpublic information in connection with the purchase or sale of a security shall be addressed. This section shall not, however, affect other prohibitions or requirements of law based, in whole or in part, on conduct other than such wrongful use or wrongful communication of material, nonpublic information.".

SEC. 3. EFFECTIVE DATE.

This Act shall take effect immediately upon enactment of this Act.

○

Exhibit H may be found following Acting Commissioner Cox' (SEC) prepared statement.

this Section, except that this paragraph shall not apply to a communication made in good faith

(i) to the officers, directors, partners or employees of the offering person, to its advisors or to other persons, involved in the planning, financing, preparation or execution of such tender offer,

(ii) to the issuer whose securities are sought or to be sought by such tender offer, to its officers, directors, partners, employees or advisors or to other persons, involved in the planning, financing, preparation or execution of the activities of the issuer with respect to such tender offer, or

(iii) to any person pursuant to a requirement of any statute or rule or regulation promulgated thereunder.

(B) The persons referred to in paragraph (2)(A) of this subsection (c) are:

(i) the offering person or its officers, directors, partners, employees or advisors;

(ii) the issuer of the securities sought or to be sought by such tender offer or its officers, directors, partners, employees or advisors;

(iii) anyone acting on behalf of the persons described in paragraph (2)(B)(i) or (2)(B)(ii) of this subsection; and

(iv) any person in possession of information relating to a tender offer which information such person knows or recklessly disregards is material and nonpublic and has been acquired directly or indirectly from any person described in this paragraph (2)(B).

(d) (1) The Commission, by rule, regulation, or order, may exempt any person, security or transaction, or any class thereof, from any or all of the provisions of this Section, upon such terms and conditions as it deems necessary or appropriate, if the Commission determines, by reason of the nature of such person, security, transaction, or class thereof, or otherwise, that such action is not inconsistent with the purposes of this Section.

(2) The prohibitions of subsections (a) and (c)(1) of this Section shall not apply to any person who is other than a natural person and who sustains the burden of proving that:

(A) the individual(s) making the investment decision on behalf of such person to purchase or sell the security, or to cause the purchase or sale of the security by or on behalf of others, did not know the material nonpublic information; and

(B) such person had implemented one or a combination of policies and procedures, reasonable under the circumstances, taking into consideration the nature of the person's business, to ensure that individual(s) making investment decision(s) would not violate subsection (a) of this Section, which policies and procedures may include, but are not limited to, (i) those which restrict any purchase, sale and causing any purchase or sale of any such security or (ii) those which prevent such individual(s) from knowing such information.

(3) The prohibitions of subsections (b) and (c) of this Section shall not be construed as making unlawful any communication made in a reasonable effort to make the information public.

(4) The prohibitions of this Section shall not make unlawful any communication made:

(A) in the ordinary course of business by a person engaged in the business of analyzing and disseminating information concerning securities, the markets for securities, or the financial condition of issuers; or

(B) to a person engaged in the business of analyzing and disseminating information concerning securities, the markets for securities, or the financial condition of issuers, if such communication is not made for the personal benefit of the person making the communication.

(5) The prohibitions of this Section shall not apply to any person who, while in possession of material nonpublic information, acts on behalf of and with the authorization of another person where the purchase, sale, or communication involved would be lawful if done directly by such other person while in possession of such information.

(e) (1) Any person who violates subsection (a) or (c)(1) of this Section shall be liable in an action in any court of competent jurisdiction to any person who, contemporaneously with the purchase or sale of securities that forms the basis of such violation, has purchased (where such violation is based on a sale of securities) or sold (where such violation is based on a purchase of securities) securities of the same class. The total liability of any person under this paragraph (1) shall not exceed the profit gained or loss avoided (within the meaning of Section 21(d)(2)(C) of this title) as a result of such person's violations of this Section.

(2) Any person (other than a person entitled to recovery under paragraph (1) of this subsection) injured by a violation of this Section in connection with such person's purchase or sale of securities may bring an action in any court of competent jurisdiction to seek recovery of any damages caused by such violation, or for appropriate equitable relief, or both.

(3) Any person who violates subsection (b) or (c)(2) of this Section shall be liable, jointly and severally, with and to the same extent as any person who gained profits or avoided losses (within the meaning of Section 21(d)(2)(C) of this title) as a result of such violation of subsection (b) or (c)(2).

(4) No action may be brought under this subsection more than five years after the date of the purchase or sale of securities that forms the basis of the violation.

SECTION 4. AMENDMENTS TO THE INSIDER TRADING SANCTIONS ACT.

Chapter 78 of title 15, United States Code, is amended, by deleting the words "in a manner other than by communicating material nonpublic information" from the first sentence of § 78u(d)(2)(B) and by striking the first two sentences of § 78u(d)(2)(A) and inserting in lieu thereof the following:

Whenever it shall appear to the Commi
16A of this title or the rules or regulations t
the facilities of a national securities exchang
and (ii) which is not part of a public offerin
standardized options, the Commission may b
court to seek, and the court shall have juris
by such person. The amount of such penalt
the facts and circumstances, but shall not ex
avoided as a result of the purchases or sales
payable into the Treasury of the United Stat

SECTION 5. AMENDMENT TO SECTION 20(d

(a) Section 78t(d) of Chapter 78 of title 15, Uni
words

Whenever communicating, or purchasin
possession of, material nonpublic informatio
any purchaser or seller of the security under
or regulation thereunder, such conduct in co

and inserting in lieu thereof the following:

Whenever communicating, or purchasin
possession of, or causing the purchase or sal
material nonpublic information would violat
connection with a purchase or sale of a note
indebtedness or similar debt security of the
information would be material with respect
security), a security convertible into or exch

(b) The Securities Exchange Act of 1934 is ame
Section 16A(f).

SECTION 6. EFFECTIVE DATE.

This Act shall take effect immediately upon

on that any person has violated Section
reunder in a transaction (i) on or through
or from or through a broker or dealer,
by an issuer of securities other than
ng an action in a United States district
tion to impose, a civil penalty to be paid
hall be determined by the court in light of
ed three times the profit gained or loss
sulting from such violation, and shall be

OF THE SECURITIES EXCHANGE ACT.

l States Code, is amended, by striking the

or selling a security while in
would violate, or result in liability to
ny provision of this title, or any rule
ection with a purchase or sale of a

or selling a security while in
of a security while in possession of.
this Section, such conduct in
bond, debenture, evidence of
uer of such security (when such
such note, bond, debenture or similar
geable for such security, or a"

ed by redesignating Section 20(d) as

nactment.

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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

- - - - - - - - - - - - - - - - -X

UNITED STATES OF AMERICA :

-against- :

DAVID W.C. CLARK, :

Defendant. :

- - - - - - - - - - - - - - - - -X

87 Cr. 49 (JFK)

OPINION and ORDER

U.S. DISTRICT COURT
FILED
JUN 30 1987
S.D. OF N.Y.

APPEARANCES:

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Of Counsel: Howard Wilson,
Assistant United States Attorney
Carl H. Loewenson, Jr.,
Assistant United States Attorney

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West Palm Beach, Florida

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JOHN F. KEENAN, United States District Judge

JOHN F. KEENAN, United States District Judge:

Background

The defendant David W.C. Clark, is the subject of a 55 count indictment arising out of an alleged embezzlement and insider trading scheme. Clark has filed three motions in this Court. He has moved for an evidentiary hearing on the reliability of polygraph tests for possible use at trial, and fo a stay of the entire case pending the Supreme Court's decision i United States v. Carpenter, 791 F.2d 1024 (2d Cir.), cert. granted, 107 S. Ct. 666 (1986). Clark further moves for a dismissal of one count on improper venue grounds. For the reasons articulated below, the Court denies the motion for an evidentiary hearing on polygraph tests, and denies the motion to dismiss the perjury count for improper venue. The Court, however, grants the motion for a stay of the entire indictment until the Supreme Court rules in Carpenter.

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Facts

The indictment sets forth a broad plan of embezzlement, fraud and insider trading taking place during the early years of this decade. Clark was an attorney with Appleton, Rice & Perrin, a New York law firm. Appleton's clients included Roger Wilson, Jr., and two of Mr. Wilson's relatives. It is charged that Clark

implemented a scheme to defraud these clients of $3.7 million from the start of 1980 to the end of May, 1984. These funds were then supposedly used by Clark to trade on inside information obtained relating to the contents of future articles in the Wall Street Journal's "Heard on the Street" column, written by R. Foster Winans.

Clark had margin accounts with two leading New York brokerage firms, Kidder Peabody & Co., Inc. ("Kidder") and Bear Stearns & Co. Clark's broker at Kidder was Peter N. Brant, an individual who was to play a major role in Winans' operation. Clark periodically received margin calls on his Kidder account that corresponded with some of the major embezzlements of Wilson's funds. The government contends that Clark satisfied the margin calls with either embezzled money or through an increase in the value of some securities purchased with material inside information.

Clark's alleged involvement in Winans' scheme began in October, 1983. On October 16, 1983, Brant and Winans supposedly struck their illegitimate deal while playing golf. Brant informed Clark of the plan two days later. Clark is not alleged to have had any direct contact with Winans; instead Brant served as their conduit. During the following four to five months,

Clark supposedly received advance notice of many "Heard on the Street" columns. However, Clark's financial situation was not cured. In late January, 1984, Clark was confronted with a margi call from Kidder for approximately $400,000. During this time, Clark represented Wilson in connection with the sale of Wilson's apartment. The sale brought roughly $740,000 into Wilson's Kidder account. Clark purportedly engineered the transfer of $420,000 from those proceeds into his own account with Kidder. The remaining proceeds were then moved into Clark's Bear Stearns account.

The indictment handed down by the Grand Jury is sweeping. Counts 1-10 concern Clark's scheme to defraud his clients through mail and wire fraud. Count 11 charges Clark wit submitting a false loan application. Counts 12-15 address Clark's tax offenses in failing to report certain funds on his personal income taxes. The insider trading issues are set forth in Counts 16-54. Counts 16-53 allege securities fraud, mail fraud and wire fraud based on Clark's stock trading with advance knowledge of the contents of Winans' columns. Count 54 charges Clark with making false statements to the Securities and Exchang Commission ("SEC") regarding his knowledge of the columns. Coun 55 alleges perjury on Clark's part when testifying before the SEC.

Each of the three motions brought by Clark will be considered in turn.

Discussion

I. The Application for a Hearing on the Reliability of Polygraph Examinations

The defendant urges that the Court hold an evidentiary hearing to determine whether polygraph examinations are reliable. The Court declines to hold a hearing because of Second Circuit precedent and an interest in conserving judicial resources.

The Second Circuit has repeatedly shown a strong disinclination to recognize polygraph test results as admissible evidence. An early indication of this position is found in United States v. Bando, 244 F.2d 833, 841 (2d Cir.), cert. denied, 355 U.S. 844 (1957), where the court upheld the trial court's ruling on a particular objection. The court acknowledged the disagreement then existing within the scientific community regarding the accuracy of polygraphs. More recently, the court again evidenced its skepticism regarding the tests. In United States v. Williams, 583 F.2d 1194, 1199 n.9 (2d Cir. 1978), cert denied, 439 U.S. 1117 (1979), the court stated that a polygraph test was more speculative than a spectrographic voice analysis, test which analyzes sound and can be used for voice identification. The court found that a polygraph test depends on the examiner's skill, the types of questions posed and the variations in blood pressure caused by how accustomed a person is to lying.

The law in this circuit is clear. Polygraph examinations are viewed by the court of appeals with suspicion and are inadmissible. Even if it wanted to, this Court is not i a position to change this rule and does not wish to spend important court time hearing evidence only to reach a preordaine result. Polygraph evidence will not be admitted during the tria of this case and the Court declines to hold an evidentiary hearing relating to such evidence.

II. The Motion for a Stay

Clark moves to have the trial of the entire indictment stayed pending the Supreme Court's resolution of Carpenter, (p. 2 supra), a case that will directly effect Counts 16-54, and impact how the rest of the case will be tried. The Carpenter appeal is scheduled to be heard during the October Term of the Supreme Court. Carpenter presents the Supreme Court with a majo securities law question: the validity and scope of the misappropriation theory. While the Court recognizes that a tria during Carpenter's pendency is possible, it is this Court's view that such an approach is inefficient and not in the furtherance of the administration of justice.

If the convictions of Carpenter, Winans and Felis are set aside, the insider trading counts against Clark must fall. It would be unfair to the defendant to make him undergo the ordeal of a trial under such circumstances. It would also be a significant waste of judicial resources. Indeed, "[n]either the

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public interest, nor the courts, nor society would be served by a lengthy trial which might prove to be unnecessary." United States v. Levasseur, 635 F. Supp. 251, 255 (E.D.N.Y. 1986).

If the convictions in Carpenter are affirmed, they will almost assuredly impact upon the Court's charge to the jury in this case. In addition, the Supreme Court might affirm the convictions, but in a manner that creates doubt as to whether misappropriation liability reaches Clark, a man not employed by the Wall Street Journal and who had no direct dealings with Winans. This Court clearly has no advance knowledge as to what the Supreme Court might do in Carpenter. It is not speculation, however, to conclude that a ruling in Carpenter will in some way effect the instant indictment. [1]

Regardless of the Carpenter outcome, Clark still faces serious charges of embezzlement. The government urges that, even if a stay is imposed on the insider trading counts, these embezzlement counts proceed. To do this, however, presents several problems. There would be overlap regarding proof of stock trading in order to show motive for embezzlement. Thus, an embezzlement trial will not be that much shorter than a trial on all counts in spite of the government's protestations to the

1. It must be noted that on June 24, 1987, the date of the oral argument on these motions, the Supreme Court decided McNally v. United States (No. 86-234). In it, the Court held that the mail fraud statute, 18 U.S.C. 1341, is "limited in scope to the protection of property rights." In submissions subsequent to oral argument, and the McNally decision, the defense argues that McNally impacts directly on Carpenter, and thus this case; the government argues that McNally has no effect at all. This Court is inclined to agree that McNally could have a direct bearing on the Carpenter appeal.

contrary. In addition, Peter Brant, a Carpenter player, would testify in an embezzlement trial. Brant pleaded guilty to federal securities law violations based on the same theory of liability that led to the Carpenter convictions. On the witness stand, these guilty pleas will certainly be revealed. Brant's criminal status could clearly spill over and injure Clark's standing before the jury in light of their close association. If the Carpenter convictions were to be reversed, Brant's guilty pleas probably would be vacated. However, the prejudicial effect to Clark would be difficult to erase. Indeed, the harm could not be erased if Carpenter were decided after Clark were convicted of the embezzlement counts.

In light of the foregoing, the Court stays this entire indictment pending the Supreme Court's ruling in Carpenter. The time between now and the Carpenter decision is excluded from the Speedy Trial Act clock under 18 U.S.C. § 3161(h)(8)(A). This is being done with the defendant's specific consent. The ends of justice are best served by this stay, which is dictated by the notions of fairness to the defendant and judicial economy. [2]

dg

2. The Court notes that by this decision it may be allowing related civil litigation Wilson v. Clark, et al., 84 Civ. 5076 (LBS), which is consolidated with Clark v. Kidder, Peabody, et al. 86 Civ. 377 (LBS) before Judge Leonard B. Sand of this court to proceed before this criminal trial. It would be preferable to have this criminal trial proceed first. Indeed after the June 24, 1987 oral argument on these motions the Court received a letter from counsel for Kidder, Peabody urging the Court to deny the stay so this criminal case could proceed first. The Court is cognizant of, and respects, Judge Sand's desire to move his civil calendar, but feels that the uncertainty created by the Carpenter appeal and the McNally decision requires this Court to wait until the Supreme Court rules in Carpenter.

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III. The Improper Venue Motion

Count 55 charges Clark with perjury in connection with testimony he gave in the District of Columbia before the SEC. Clark argues that venue is properly in the District of Columbia and, for that reason, Count 55 should be dismissed. The government responds that under United States v. Reed, 773 F.2d 477 (2d Cir. 1985), venue is also proper in the Southern District of New York. The policy considerations articulated by the Second Circuit in Reed mandate the conclusion that Count 55 can be brought in this Court.

On March 14, 1984, the SEC issued a formal order of investigation concerning Clark's stock trading. As part of the investigation, numerous depositions were taken in the Southern District of New York. The investigation's subject matter concerned activities occurring exclusively within this district. The investigation led to a civil action filed by the SEC against Clark in this district. Clark's own deposition, however, was conducted in the District of Columbia. The scenario in Reed was different. The defendant was accused of committing perjury during a deposition taken in San Francisco. The deposition was part of a civil action commenced in the Southern District of New York. Reed, 773 F.2d at 478.

The narrow question in Reed was "whether perjury committed in an ancillary proceeding may be prosecuted in the district in which the parent proceeding is pending, as well as in the district in which the oath was taken." Id. at 483 (footnote omitted). The court answered in the affirmative. Id. at 484. In doing so, the court set forth a substantial contacts analysis that considered, "the site of the defendant's acts, the elements and nature of the crime, the locus of the effect of the criminal conduct, and the suitability of each district for accurate factfinding." Id. at 481. The Court deems this approach applicable to the case at bar.

All factors point to this district as a proper venue. Clark testified to events that occurred here -- his trading of various stocks. The effect of the alleged criminal conduct would be felt in this district. The SEC's investigation resulted in a civil suit filed in New York. Clark's perjury would have impeded the investigation, and the SEC's suit. The charged criminal conduct to which Clark testified harmed the financial market located in the Southern District, and were part of Winans' scheme that was carried out here. These considerations lead to the conclusion that accurate factfinding could be achieved in this district.

The Second Circuit's holding in United States ex rel. Starr v. Mulligan, 59 F.2d 200, 202 (2d Cir. 1932) does not require a different result. The defendant in that case was charged with signing and attesting to a false statement on an application executed in New York, but filed in Washington, D.C.

COMPARISON OF INSIDER TRADING PROPOSALS

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	S. 1380	SEC PROPOSAL	NYSE PROPOSAL
1. INFORMATION COVERAGE/ MATERIALITY	Material, nonpublic information [relating to that security or groups of securities (or the market therefor)] [§ 16A(b)(1) & (b)(2)]	Material, nonpublic information concerning the issuer or its securities [§ 16A(a)].	Material, nonpublic information relating to that security [§ 16A(b)(3)]
2. WHAT IS WRONGFUL USE? (MISAPPROPRIATION THEORY)	Only if information is obtained by, or use would constitute, directly or indirectly, theft, conversion, misappropriation or a breach of any fiduciary, contractual, employment, personal or other relationship of trust and confidence [§ 16A(b)(1)]	If information has been obtained by or as a result of, or its use would constitute (1) theft, bribery, misrepresentation or espionage; or (2) breach of duty to keep information confidential or not trade (or cause trades) in that security, which duty arises from four specific and two catch-all categories of persons [§ 16A(a)(1) & (a)(2)]	Only if information is obtained by, or its use would constitute theft, conversion, or a breach of a fiduciary duty, a personal or other relationship of trust and confidence, or a contractual or employment relationship [§ 16A(b)(2)]

COMPARISON OF INSIDER TRADING PROPOSALS

	S. 1380	SEC PROPOSAL	NYSE PROPOSAL
3. WHAT IS WRONGFUL COMMUNICATION? (TIPPER LIABILITY)	(1) Wrongfully communicating material, nonpublic information, directly or indirectly, to any person who purchases or sells a security that is directly or indirectly the subject of the communication, where the communicator knows (or is reckless in not knowing) the information would be used for a wrongful trade [§ 16A(c)(1)]; and (2) Direct or indirect communication, by a person planning an extraordinary corporate transaction, of information concerning that transaction for purpose of influencing or encouraging a trade (and a trade is in fact made), unless communication is to member of communicator's § 13(d)(3) group, to a person acting on behalf of the communicator, or is in connection with good faith solicitation to join such a group, or securities are directly bought from or sold to the person planning the transaction [§ 16A(c)(2)].	(1) Direct or indirect communication of information known or recklessly disregarded to be material and nonpublic, by person whose own trade would violate § 16A(a), to any person who directly or indirectly trades or causes a trade or who communicates the information to another person who reasonably foreseeably trades or causes a trade [§ 16A(a)]; and (2) in the context only of tender offers, any violation of Rule 14e-3. [§ 16A(c)(2)]	Communication of material, nonpublic information to assist another person wrongfully to use the information to trade any security in violation of § 16A [§ 16A(b)(1)(ii)]

COMPARISON OF INSIDER TRADING PROPOSALS

	S. 1380	SEC PROPOSAL	NYSE PROPOSAL
4. APPLICATION TO ANALYSTS AND OTHERS	Tipping prohibitions not applicable to communications to or by an analyst or another person unless communication is made wrongfully and if person knows or is reckless in not knowing that information could be used for wrongful trade. [See § 16A(c)(1)]. Trading in possession of that information (not its intended use) would constitute misappropriation or conversion and, therefore, would be wrongful. [See § 16A(b)(1)]	Tipping prohibitions are not applicable to any communication made (1) in a reasonable effort to make the information public [§ 16 A(d)(3)]; (2) in the ordinary course of business by a securities professional or to a securities professional, so long as communication is not for the personal benefit of the communicator in cases of communications to such persons [§ 16A(d)(4)]; Prohibitions of § 16A are not applicable to persons who possess material, nonpublic information who are acting for and with authorization of a person whose direct trade or communication would be lawful if they had the same information. [§ 16A(d)(5).]	As long as the communication to or by analysts and others is not for purposes of assisting a wrongful trade, the tipping prohibition does not apply. [§ 16A (b)(1)(ii)].

COMPARISON OF INSIDER TRADING PROPOSALS

	S. 1380	SEC PROPOSAL	NYSE PROPOSAL
5. STATUS OF RULE 14e-3	Rule would be withdrawn, § 16A would provide exclusive standard for insider trading cases [§§ 16A(a)(4), 16A(g)].	Rule 14e-3 would be codified, almost in its entirety, [§§ 16A(c)(1); 16A(d)(2)]; Rule 14e-3 (anti-tipping rule in context of tender offers) would also be codified [§ 16A(c)(2)]	Same as S. 1380.
6. MULTI-SERVICE FIRM PROBLEMS/DERIVATIVE LIABILITY	No derivative liability based solely on employment or control of violator [§ 16A(d)]; if facts beyond employment or control are alleged, multi-service firm can escape trading liability if (i) the trade was not influenced by material, nonpublic information in firm's possession; and (ii) the person effecting or causing the trade did not know the information; implementation and maintenance of reasonable policies and procedures designed to prevent violations are relevant to firm's burden of proof [§ 16A(b)(2)].	Multi-service firm can escape trading liability if the firm can prove that (i) the person making the investment decision or causing the trade did not know the information; and (ii) the firm had implemented procedures to ensure that its employees do not violate § 16A [§ 16A(d)(2)].	Same as S. 1380.

COMPARISON OF INSIDER TRADING PROPOSALS

	S. 1380	SEC PROPOSAL	NYSE PROPOSAL
7. PRIVATE RIGHT OF ACTION	Right of action available to any person injured by a violation of § 16A; Persons trading contemporaneously with violator deemed injured; Damages limited to profits gained or losses avoided, and are diminished by any amount disgorged in related government action; Tippers jointly and severally liable with their tippees; Five-year statute of limitations [§ 16A(f)].	(i) Absolute liability for damages imposed on persons found to violate § 16A(a) or (c)(1), to persons who traded contemporaneously; Damages limited to profits gained or losses avoided [§ 16A(e)(1)] no offset for disgorgement paid; (ii) any person otherwise injured by a violation of § 16A may seek damages or equitable relief; No limitation on damages [§ 16A(e)(2)]; severally liable with their tippees; five-year statute of limitations [§§ 16A (e)(3) & (e)(4)].	No provision.
8. FINDINGS/EXCLUSIVITY	Policy statement re: need for and benefits of exclusive standards [§ 16A(a)(4)]; Operative clause stating that § 16A shall provide the exclusive standards.	Policy statement re: appropriateness of exclusive standards would not be part of § 16A [See Section 2]	Policy statement re: need for and benefits of exclusive standards [§ 16A(a)(3)].

tions relating to the same securities in which they make markets.[10]

Accordingly, the Commission invites comments on the questions of whether and to what extent, the various participants in the exchange and over-the-counter markets whose activities may effect the pricing mechanism of securities traded therein should be permitted to have an interest in options in the same securities. Commentators should address themselves to the following considerations, among others:

1. the possibility that such dealing might create for a participant a conflict of interest which would likely impair the maintenance of fair and orderly markets in the underlying securities where the participant is (a) a specialist (b) an odd-lot dealer (c) a floor trader (d) a market maker in listed securities on an exchange and/or a third market maker (e) a market maker in over-the-counter securities or (f) a block positioner in listed and unlisted securities;

2. the relevance and significance of changed market conditions, since the passage of the Securities Exchange Act, including changes that have taken place in the structure of exchange and over-the-counter markets (such as the relative "institutionalization" of the markets);

3. the future development of a central market system;

4. the significance of the differences, if any, among various categories of members on regional and primary exchanges, including differences with respect to their abilities to affect the pricing mechanism of a given security, and the nature of their respective contributions to the market;

5. the adequacy of present or potential regulatory controls to prevent misuse of options in the event present restrictions were relaxed.

All interested persons are invited to submit their views and comments on the foregoing issues. Written statements of views and comments should be addressed to Ronald F. Hunt, Secretary, Securities and Exchange Commission, 500 North Capitol Street, Washington, D. C. 20549, on or before September 29, 1973. Reference should be made to file number S7-490. All such communications will be available for public inspection.

By the Commission.

[¶ 79,446] SEC Inquiry Into Use of Undisclosed Material Information in Connection with Purchase or Sale of Securities.

Exchange Act Release No. 10316. August 1, 1973. Release in full text.

Material Information Previously Undisclosed—Purchase or Sale of Securities—Comments Invited.—The SEC has invited comments from members of the securities industry and the investing public concerning the utilization of previously undisclosed material by prospective purchasers or sellers of securities. The SEC requests comments concerning, among other matters, the procedures employed by issuers to insure that material information is not improperly utilized on a selective basis and the procedures and methodology utilized by financial analysts to formulate their securities recommendations. Comments should be mailed on or before October 15, 1973.

See ¶ 22,721 and 22,725, "Exchange Act—Manipulations" division, Volume 2.

The Securities and Exchange Commission announced today that, with respect to an inquiry already underway by its staff into the circumstances under which material information of a previously undisclosed nature may be utilized in connection with the purchase or sale of securities, it is soliciting the comments and views of all members of the securities industry and the investing public.

The Commission staff's examination includes, among other things, an inquiry into the following major issues:

(1) When information should be considered to have been publicly disseminated. Among other things, the Commission's staff is seeking to determine whether guidelines can be established concerning appropriate waiting periods to be applied after material information about an issuer

[10] See *Report of Special Study of Securities Markets of the Securities and Exchange Commission* which discusses some of the problems concerning trading in options relating to over-the-counter securities prior to the NASDAQ system. H. R. Doc. No. 95, 88th Cong., 1st Sess. (1963) Pt. 2, pp. 563-567, 676.

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has been disclosed in various available ways before any person in possession of such previously undisclosed information may trade in reliance upon that information. Views are also solicited regarding the efficacy of existing procedures that are followed, both by corporations and financial analysts, concerning information which has been disclosed on a limited basis—for example, information filed with governmental agencies.

(2) Whether appropriate guidelines can be established to determine when information concerning an issuer is material. Among other things, the Commission's staff is considering under what, if any, circumstances nonpublic information may be disclosed to and utilized by securities professionals in the absence of any general public dissemination of that information, where for example, the information, standing alone, is material only to securities professionals closely following a particular issuer or industry.

(3) Whether guidelines can be established to designate categories of individuals and entities which may be considered to have a sufficient nexus to preclude their use of material, undisclosed information concerning the issuer, in the absence of any general public disclosure of that information. Consideration is being given, for example, to information derived from suppliers or competitors, among others.

(4) Whether and to what extent selected, nonpublic knowledge about the existing or future market in particular securities should be treated as material information which must be disclosed by securities professionals or other persons prior to any transactions in those securities.

In connection with these broad topics, the Commission requests comments concerning:

(1) the procedures presently employed by broker-dealers and financial analysts to insure that they and their employees do not engage in any act or practice which may constitute an improper dissemination or utilization of material nonpublic information;

(2) the procedures presently employed by issuers to insure that material information is not improperly disclosed or utilized on a selective basis;

(3) any procedures presently employed by issuers to determine whether, when and how material corporate information should be disclosed publicly;

(4) the procedures and methodology utilized by financial analysts to formulate their securities recommendations; and

(5) the appropriateness of utilizing nonpublic material information directly related to the future market for a given security, which does not emanate from or concern the issuer of that security.

In addition to comments relating to existing procedures, the Commission's staff is interested in any facts or information which may reflect upon the appropriate resolution of the issues discussed above and any related matters.

Comments are invited from all interested persons and should be addressed to Harvey L. Pitt, Chief Counsel, Division of Market Regulation, Securities and Exchange Commission, 500 North Capitol Street, Washington, D. C. 20549. Comments should be mailed so that they may be received before August 31, 1973.* All comments received will be made publicly available.

By the Commission.

[¶ 79,447] **NYSE Position on Central Market System.**

The New York Stock Exchange, Research Department. July, 1973. Summary and recommendations.

NYSE Policy Statement—Central Market System.—The New York Stock Exchange has issued a comprehensive analysis of issues involved in the development of the central market system. These included the need for the ultimate elimination of fixed commission rates on all orders *concurrently with* a requirement that all trades of listed securities be made on registered national securities exchanges operating under similar rules and regulations. It also proposed a requirement that exchange member broker-dealers must do 100% of their business with unaffiliated public customers. The Board of Directors called for a combined program of legislation and regulation to accomplish these objectives.

See ¶ 21,305, "Exchange Act—Definitions; Exchanges" division, Volume 2.

SUMMARY AND RECOMMENDATIONS

The central objective of preserving and strengthening exchange auction markets for listed securities—which is crucial to the development of a viable central market system—is inseparably related to a number of key issues which the industry has been

* Extended to October 15, 1973 in Release No. 34-10371. CCH.

Senator RIEGLE. Mr. Phillips, I think what we will do before we get into questions is to ask you now to present your testimony. Let me say that we appreciate your being here on behalf of the New York Stock Exchange and we would be pleased to hear from you now.

STATEMENT OF RICHARD M. PHILLIPS, ESQ., ON BEHALF OF THE NEW YORK STOCK EXCHANGE LEGAL ADVISORY COMMITTEE

Mr. PHILLIPS. Senator and members of the committee, I am pleased to testify on S. 1380 as a member of the Legal Advisory Committee of the New York Stock Exchange. We do not speak for the exchange itself but only for the advisory committee.

STATUTORY DEFINITION

The advisory committee on June 30 of this year issued a report that contained a proposal for a legislative definition of insider trading. There are some differences between S. 1380 and this proposal. One of them is very important. But in the main, the approach is very similar and the ability of two groups of corporate and securities lawyers, working in coordination but making independent judgments, to reach a consensus on a statutory definition that will define with greater precision the crime of insider trading without interfering with the legitimate flow of market information, is a very important fact. It demonstrates that it can be done, when there were those who said it's much too complicated.

The unifying principle of both the Legal Advisory Committee proposal and S. 1380 is very simple. If one obtains information honestly, one can use it. If one obtains it dishonestly by trickery, fraud, misappropriation, breach of duty, one cannot use it. This guiding principle forms a basis for a definition of insider trading that will clarify and strengthen the law.

The SEC's proposal, I agree with the other witnesses, is a major step forward because what the SEC has done by its definition is to renounce its adherence to a theoretical doctrine of information parity and recognize that a statutory definition can be useful to improve its enforcement program and to extend much needed clarity into the law.

The SEC proposal, however, has a number of problems. First of all, compared to S. 1380 or the Legal Advisory Committee proposal, it's extraordinarily complex. I don't think I really understand many of the provisions and I wonder whether the SEC does.

As a lawyer in private practice who defends insider trading cases, I see lots more arguments for a defendant in that draft than I do under present law and certainly under S. 1380 or our proposal.

The arguments may not win, but the draft is so complicated that we defense lawyers can do a job with it.

In other respects, however, the proposal is just unnecessarily and perhaps thoughtlessly restrictive. I think the basic problem is that its treatment of the communication of information is seriously flawed. It broadly prohibits the communication of material nonpublic information and then creates a number of vague exceptions, and the vagueness of the exceptions compound the problem.

Take the exception for communications to a person engaged in the business of analyzing and disseminating information. Why should there be a distinction between the professional and the nonprofessional investor in terms of the ability to obtain and use information? Neither S. 1380 nor the Legal Advisory Committee proposal makes that distinction and we don't think it need be made.

The exception has no definition. Is it really limited to the financial press? The exception requires that a person both analyze and disseminate. Does it extend to an analyst for a mutual fund who analyzes information but doesn't disseminate it? Does it extend to a broker-dealer who analyzes information, issues a recommendation, but doesn't disseminate the information? The exception is not clear. That's one of the problems with this statute.

The statue has other problems and there's one of them I'd like to focus on because the same problem appears in S. 1380. Insofar as individuals are concerned, both S. 1380 and the SEC proposal differs from the Legal Advisory Committee's position. It makes an individual who trades while in possession of inside information liable both civilly and criminally, regardless of any proof that he used the information and, indeed, in the face of conclusive proof that he did not use the information. It is in fact, whether or not by name, an irrebuttable presumption of guilt through possession.

But information is not a drug. It's not a dangerous substance, and it should not be treated that way. The fact of the matter is, we all are deemed in possession of material on our desk and in our files. Do we know everything that's in our files? But under the approach taken by the SEC, as well as S. 1380, if we trade in a security and we have information in our files, whether or not we knew it, we are guilty. We are subject to criminal liability as well as a civil penalty treble the amount of the profits earned or the losses avoided, disgorgement of the additional amount of profits or losses, and unspecified damages to persons who may be injured by the trading. That's bad law. That's bad policy. And it simply isn't necessary.

Yes, I know that the SEC—and I served for 8 years as a staff member of the SEC—I know the SEC hears a lot of stories from a lot of individuals in the course of their investigation. The fact of the matter is, they don't believe them and most of those stories go nowhere except into a record that's disregarded because they are not believable.

But there are situations where individuals may be deemed in possession of information that they aren't aware of and didn't use in connection with trading. It's just wrong to say, regardless of the facts that you're guilty of trading on inside information. That's a defect not only in the SEC's proposal but in S. 1380, and I urge this committee to reconsider that issue.

There are other problems with the SEC's version which I think are corrected by S. 1380. The difficulties with the SEC proposal should not obscure the fact that a significant step forward has been made by the efforts of this committee and the willingness of the SEC to respond to this committee's request in a responsible, meaningful way.

I think it demonstrates that there's hope that the differences between all the proposals can be reconciled and we are pleased to have been of assistance in working toward the development of a statutory definition of insider trading which we regard as a very important project.

[The complete prepared statement of Richard M. Phillips follows.]

with the Civil Service Commission. The Court ruled that venue was only proper in New York. That case essentially addressed whether the filing in one district of a false statement made in another district, establishes venue in the district where the document was filed. The facts of this case are far more akin to Reed than Starr.

Conclusion

The defendant's application for an evidentiary hearing and his motion to dismiss Count 55 are denied. The defendant's motion to stay the trial of this indictment pending the Supreme Court's action in Carpenter is granted. For the reasons stated above, in the interests of justice, the period of the stay is excludable time from the provisions of the Speedy Trial Act. Th Court will set a status conference for one week after the Supren Court acts in Carpenter. At that time, an early trial date will be fixed.

SO ORDERED.

Dated: New York, New York
June 30, 1987

John F. Keenan

JOHN F. KEENAN
U.S.D.J.

COMPARISON OF S. 1380 AND SEC PROPOSAL
(August 7, 1987)

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Major Points of Consensus	Major Points of Variance
1. Appropriateness of Congressional Findings	1. Statutory Codification of Findings
2. Effective Prohibition Against the "Wrongful" Obtaining or Use of Inside Information	2. Scope of the Term "Wrongful"
3. Adoption of "Possession" Test	3. Application to Market Information
4. Creation of Affirmative Defense for Multi-Service Financial Institutions	4. "Bad Apple" Defense/Relevance of Firm Procedures
5. Elimination of Dirks "Personal Benefit" Test	5. Application of Tipping Prohibition to Arbitrage and Other Non-Tender Offer Transactions
6. Express Prohibition Against "Tipping"	6. Continued Utility of Misappropriation Theories
7. Exclusivity	7. Effectiveness of Non-Statutory Exclusivity "Finding"
8. SEC Exemptive Authority	8. Scope and Placement of "Jurisdictional Means" Test
9. Express Private Remedy	9. Scope and Theory of Private Recovery
10. Recognition of Legitimate Analyst Functions	10. Breadth of Statutory Safeguards for Legitimate Analyst Functions

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STATEMENT OF RICHARD M. PHILLIPS
BEFORE THE SECURITIES SUBCOMMITTEE
OF THE SENATE BANKING, HOUSING AND
URBAN AFFAIRS COMMITTEE
ON S.1380, THE "INSIDER TRADING
PROSCRIPTIONS ACT OF 1987"
August 7, 1987

I. INTRODUCTION

Mr. Chairman and Members of the Subcommittee, my name is Richard M. Phillips. I am an attorney in private practice with the Washington, D.C. law firm of Kirkpatrick & Lockhart. I have specialized in the practice of securities law for more than 25 years, first as a member of the staff of the Securities and Exchange Commission and more recently in private practice. I am a member of the New York Stock Exchange's Legal Advisory Committee, and Chairman of its Subcommittee on Regulation of Tender Offers.

I am pleased to appear here today to testify on S.1380, the "Insider Trading Proscriptions Act of 1987," as a representative of the NYSE's Legal Advisory Committee. The Legal Advisory Committee, directly and through its various subcommittees, pro-vides guidance to the Exchange's Board of Directors on a broad range of issues.

On June 30, 1987, the Legal Advisory Committee issued a report proposing a statutory definition of insider trading. The report has been sent to member firms and listed companies for their comments. But it has not been adopted in any sense by the Exchange. Thus, the views that I present do not necessarily reflect the views of the Exchange itself or, indeed, my law firm

or any client of my firm. I would like to submit for the record a copy of the report, which is attached to this statement.

The report was made as the result of a request made in early 1987 by Chairman John J. Phelan, Jr., for a definition of insider trading which could be considered by the Exchange and perhaps submitted to Congress for its consideration. The report was being prepared at the same time that the group, headed by Harvey L. Pitt, was developing the proposal which ultimately was introduced as S.1380. The Advisory Committee report is a product of several months of work, initially by the Subcommittee on Regulation of Tender Offers under my direction and later by the full Legal Advisory Committee under the direction of outgoing Chairman Linda A. Wertheimer. We worked in close coordination with the Pitt group during the course of our deliberations. Indeed, I was also an ad hoc member of the Pitt group.

It is important to stress, however, that the proposed definition represents the Legal Advisory Committee's independent judgment concerning the need for and proper approach toward a statutory definition of illegal trading on the basis of material, nonpublic information. The Advisory Committee's proposal represents the collective judgment of a broad cross-section of the legal community -- members of the private securities bar, general counsels of member firms and companies listed on the Exchange, members of the academic community, and a former United States District Court Judge.1/ It reflects their collective

1/ Several members of the Committee deserve special mention for (footnote continued)

judgment that this proposal would be effective in prohibiting insider trading, without unnecessarily interfering with the free flow of information to the marketplace -- which, I believe, should be an essential legislative goal.

The significance of our proposal lies not in its differences with S.1380 but rather in its essential similarity with the bill. The proposal confirms the proposition that broad agreement can be reached on the need for, and the substance of, a statutory definition of insider trading. Specifically, the Advisory Committee report and accompanying proposal support the following conclusions that are incorporated in S.1380:

- insider trading provisions should be designed to protect the integrity of our securities markets, without interfering with the free flow of information which is also vital to our markets;
- the current law is inadequate both in terms of providing guidance to those seeking to conform their conduct to the law and in terms of giving the government sufficient authority to reach all cases of trading which should be prohibited;
- the best approach for accomplishing these goals is to prohibit trading advantages obtained by improper means rather than to impose an absolute parity of information requirement which would obstruct the flow of information into

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(footnote continued from previous page)
their contributions to the report: Chairman Linda Wertheimer, Vinson and Elkinds; Jean Allard, Sonnenschein, Carlin, Nath, and Rosenthal; Joseph McLaughlin, General Counsel of Goldman, Sachs & Co.; Charles B. Renfrew, former United States District Court Judge of the Northern District of California and Vice President-Legal Affairs of Chevron Corporation; and Frank R. Morris, Jr., Porter, Wright, Morris and Arthur. In addition, Larry Lavoie of my firm served as reporter to the Committee and contributed substantially to its report.

the marketplace;

* multi-service firms should not be liable for insider trading violations merely because one department had possession of material, nonpublic information which was not known by individuals in the trading department and which did not influence their trading decisions; and

* the standards of conduct specified by the new statute would be exclusive so as to bring certainty into the law.

The key provisions of the Advisory Committee's proposal are: (1) a broad prohibition on trading on the basis of material nonpublic information by persons who have been entrusted with such information for nontrading purposes, as a result of their employment or some confidential business or personal relationship, or who have obtained information by theft, misappropriation, conversion or other improper means; (2) a prohibition on communication of material nonpublic information to any other person (commonly known as "tipping") for purposes of assisting the other person to violate the trading prohibition; and (3) a rebuttable presumption that a person has used material, nonpublic information when he engages in trading while in possession of such information. The intended applications of these provisions are spelled out in our report.

The important point, from the Legal Advisory Committee's perspective, is that the proposal is intended not only to codify and clarify existing law, but also to extend it and to remove some of the existing impediments to an effective prohibition of trading on he basis of material, nonpublic information. Like

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S.1380, therefore, the Legal Advisory Committee's proposal is intended to ensure that the government would have authority to prosecute all cases covered by existing law and to extend its authority to cover some conduct which may not now be covered by the law.

I am gratified that the SEC has submitted a proposal for defining insider trading which appears to embrace some of these concepts. The SEC's proposal: (1) uses, at least as a starting point, the concept of wrongful acquisition and use of information, rather than parity, as the basis for an insider trading provision; (2) provides authority for analysts and corporate officials to communicate with each other, in connection with good faith research, without undue fear of liability concerning hindsight judgments concerning the nature of information being communicated; and (3) embraces the concept of exclusivity.

There are a number of important areas in which we differ with the SEC's proposal. But the SEC's proposal is a far more reasonable attempt to deal with the problem than would have been indicated by Acting Chairman Cox's prior testimony before this Subcommittee which, we believe, incorrectly criticized S.1380 as cutting back on the law.

I would like to discuss specifically the areas in which the Legal Advisory Committee report concurs with S.1380, and its reasons for doing so. Further, I will discuss those areas of the SEC's proposals and certain provisions of S.1380 which, I

believe, are most troublesome from the Committee's perspective.

II. COMMENTS ON S.1380

A. The Insider Trading Laws Should Be Designed To Promote Confidence In The Securities Markets, Without Interfering With The Free Flow Of Information Into The Marketplace

The preamble to S.1380 correctly recognizes that, although an insider trading prohibition is necessary to promote investor confidence in our markets, there is an important public interest in preserving the free flow of investment information into the marketplace. The Legal Advisory Committee came to the same conclusion.

The Legal Advisory Committee concluded that a definition of insider trading based on a possession theory and theoretical goal of parity of information would be inconsistent with the disclosure philosophy of the federal securities laws. It would do far more harm than good for investors by impairing the flow of investment information into the market. A definition of illegal trading should not be so restrictive that it chills the healthy dialogue which occurs between corporate executives and securities analysts doing honest research.

Every day, analysts communicate with corporate officials seeking information to fill in the interstices of their analysis. They ask questions which seek to go beneath the surface of reported information, and use the answers obtained to form judgments as to the investment worth of securities. In this

manner the analyst supplements and enforces the specific disclosure requirements of the SEC and the Exchanges.

The insider trading provisions could, if not carefully crafted, result in the antithesis of full disclosure -- an environment of corporate secrecy in which ultimately the investor would be the loser. If insider trading liability were to turn solely on possession of material, nonpublic information, the dialogue between corporations and analysts would grind to a halt.

The concepts of "materiality" and of "nonpublic" information are extremely ill-defined. For every clear case, there are many situations where questions of whether information is material or nonpublic are matters of judgment on which reasonable persons may differ. If corporate executives and analysts seeking to give each other honest answers to honest questions were exposed to prosecution on the basis of hindsight determinations that information communicated by them were deemed material and nonpublic, they would be deterred from communicating with each other for fear that something material and nonpublic may slip out. This approach would encourage corporate secrecy and discourage corporate openness. Indeed, some companies might use potential liability as an excuse for withholding "bad news" and leave the investing community dependent on what they chose to disclose.

The Legal Advisory Committee, therefore, concluded that the definition of illegal insider trading should and could be drafted to prevent misuse of material, nonpublic information without

unnecessarily discouraging the free flow of information to the marketplace. The definition could accomplish this goal by focusing on the wrongful obtaining and use of information for trading purposes, and not on restricting the flow of information to the marketplace by basing liability on the mere possession or communication of information. In simple terms, a statutory definition of insider trading should not deter the corporate executive from giving "an honest answer to an honest question" by market participants engaged in legitimate research.

B. The Current Law Is Inadequate Both In Terms Of Providing Guidance To Those Who Seek To Conform Their Conduct With The Requirements Of The Law And In Terms Of Covering All Conduct Which Should Be Prohibited

The preamble to S.1380 states that the "specific delineation" of the offense of insider trading is needed to promote "greater clarity in the law." The Advisory Committee's report fully agrees with this conclusion.

The Advisory Committee's report points out that clarification of current law is necessary to provide guidance to market participants and to ensure that all conduct which should be prohibited is in fact covered by the law. There is currently no consistent theory of what constitutes insider trading. The Supreme Court's decisions in Chiarella[2/] and Dirks[3/] have forced the government to rely on a patchwork system of prohibitions with

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2/ Chiarella v. United States, 445 U.S. 222 (1980).

3/ Dirks v. S.E.C., 463 U.S. 646 (1983).

no unifying theme -- the fiduciary duty theory, the misappropriation theory, and Rule 14e-3. The potential gaps and confusion in this system are discussed in our report.

It is too simplistic, however, to blame the Supreme Court for creating the current confusion in the law. The Court's decisions in Chiarella and Dirks were in fact a reaction to a serious lack of clarity in the law. Prior to Chiarella and Dirks, the law failed to provide adequate notice to market participants to guide them in making day-to-day decisions concerning the communication and use of information. The Court attempted to provide a unifying principle and objective standards which the average person could apply with reasonable certainty. In the process, the Court created potential gaps in coverage of our insider trading laws -- especially with respect to trading advantages obtained by theft, misappropriation, or conversion of confidential information.

The government has attempted to fill these gaps with the misappropriation theory which now appears to be the primary basis for many insider trading prosecutions. It is the theory under which R. Foster Winans was prosecuted for trading on information obtained from his employer, the Wall Street Journal.[4/] The validity of that is, of course, now before the Supreme Court.

Under the current law, the misappropriation theory is oriented to the protection of the employer. The securities laws, however, are not designed to protect employers; they are designed

4/ United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986), cert. granted, 107 S. Ct. 666 (1986).

to protect the nation's capital markets and the investors who participate in those markets. Thus, it is quite possible that the courts will require, as a prerequisite for application of the misappropriation theory, proof of economic injury to an employer -- a proof that is wholly irrelevant to the protection of the markets and investors. Thus, even if the misappropriation theory is accepted in the Winans case, there is no assurance in the present statutory context that it will be adequate to satisfy the purposes of the federal securities laws.

Both S.1380 and the Advisory Committee's proposal would codify the misappropriation theory. They would do so not to protect the employer, but to protect the markets. Thus, they would re-focus the theory to make clear that injury to the employer is irrelevant. Trading on the basis of misappropriated information should be illegal because it harms the markets and those who participate in those markets, and not because it harms private interests of employers.

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While the Legal Advisory Committee agreed that greater clarity in the law was desirable, it reached no conclusion on the timing of Congressional action. Some members believed Congress should wait for the Supreme Court to rule in the Winans case before Congress acts. Others believed that, regardless of the outcome of the Winans case, the offense should be defined to promote clarity.

The difference of opinion within the Legal Advisory Committee, however, relates primarily to timing, not to

substance. All agree that effective prohibitions against inside trading are essential to protect investor confidence in our nation's securities markets. All agree that an effective definition of insider trading is too important to leave for possible development by the courts. It ultimately will require Congressional declaration that misuse of material nonpublic information is undermining confidence in the fairness of our securities markets and is illegal. It is the function of the Congress, not the courts, to make that declaration.

Subsequent to the completion of the Legal Advisory Committee's Report, the Supreme Court issued an opinion which may confirm the need for Congress to define insider trading. In McNally v. United States,5/ the Court reversed a mail fraud conviction which was based upon the theory that the defendants had defrauded the citizens of Kentucky of their "intangible rights" to honest and fair government. The Court reasoned that, although the mail fraud statute could be construed to cover thefts of intangible rights, it would not construe the statute i that manner in the absence of a "clear and definite" mandate fro Congress. The Court explained:

> Rather than construe the statute in a manner that leaves its outer boundaries ambiguous and involves the Federal Government in setting standards of disclosure and good government for local and state officials, we read § 1341 as limited in scope to the protection of property rights. If Congress desires to go further, it must speak more clearly than it has.6/

5/ No. 86-234 (S. Ct. June 24, 1987).

6/ Slip op. at 9 & 10.

The McNally case raises substantial doubts concerning the government's ability in the future to prosecute cases, such as the Winans case, which rely on the misappropriation theory. First, the mail fraud statute is arguably no longer a basis for prosecution of persons such as Winans in the absence of proof that their conduct caused someone to suffer a specific loss of money. Prosecutors have publicly conceded that McNally will create problems for them in using the mail fraud statute in insider trading cases.7/ Second, if the Court's reasoning in McNally is applied to the insider trading laws under the federal securities laws, principally Section 10(b) of the 1934 Act and Rule 10b-5 thereunder, the Court could well conclude that the provisions are too ambiguous to support the misappropriation theory. Only time will tell how the Court will rule.

C. The Offense Of Insider Trading Should Focus On Whether Information Has Been Wrongfully Obtained Or Used

Both S.1380 and the Advisory Committee's proposal agree on the manner in which the offense of insider trading should be defined. S.1380 would prohibit a person from using material, nonpublic information in trading only if the person knows or is reckless in not knowing that the information was obtained by or its use would constitute "theft, conversion, misappropriation or a breach of any fiduciary, contractual, employment, personal or other relationship of trust or confidence." S.1380 would, with

7/ "Business and the Law: Ruling Clouds Insider Trading Cases," The New York Times, June 29, 1987, at D2.

one exception, make communication of information unlawful only if the person making the communication knows or is reckless in not knowing that the recipient will use the information wrongfully within the meaning of the bill.

The Advisory Committee proposal uses virtually the same language and approach to defining the offense of insider trading and tipping. This approach provides a uniform theory whether the defendant is a corporate insider or outsider -- use of information that is obtained by dishonest means or which violates a duty owed by the trader is unlawful. Information obtained by honest efforts can be used.

The Advisory Committee agrees with the Pitt group that this approach reaches all conduct which is currently prohibited and, in fact, extends the law by embracing a broad-based misappropriation theory. The definition would make clear that federal law prohibits use of stolen or misappropriated information -- despite the fact that the information may be an intangible right.

As the Advisory Committee report points out, the offense of insider trading should focus on the harm to the market itself rather than to specific individuals. Thus, the Legal Advisory Committee's proposal would not require proof that the owner of the information suffered any economic injury as a result of the use of the information for trading. This would relieve the government of the burden of demonstrating the type of economic injury which, in all likelihood, will be required in insider

trading prosecutions subsequent to McNally.

Another benefit of this approach is that it would specifically deal with the abuse of personal relationships. Today, if an executive conveys information to a friend or relative for a proper purpose, with no expectation that the information will be used for trading, the law is unclear as to whether the recipient of the information may use the information. The definition would clarify that misappropriation of information obtained in the context of a personal relationship is prohibited. This should enhance the government's ability to prosecute cases such as the Reed and Lund cases.8/

The Advisory Committee concluded that by focusing on the wrongful nature of the acquisition or use of the information, rather than its mere possession, the definition would leave breathing room for honest research. The primary distinction between the basic definition contained in S.1380 and the Advisory Committee's proposal is in the area of bidder tipping in the corporate control context. The provisions of S.1380 goes beyond use of stolen or misappropriated information about a tender offer -- the type of conduct involved in Chiarella and other cases -- and attempts to prohibit communications by tender offer bidders that are designed to put the target "into play."

The Advisory Committee determined not to address this subject on the ground that the conduct at issue involves a tender offer tactic rather than insider trading, and that the topic is

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8/ United States v. Reed, 601 F.Supp. 685 (S.D.N.Y. 1985); SEC v. Lund, 570 F.Supp. 1397 (C.D. Ca. 1983).

better addressed in the context of tender offer reform which addresses bidder and target tactics. Moreover, the provision is likely to have no effect on bidders who want to put the target into play before announcing a tender offer. The bidder can "telegraph" its interest to the Street in many ways without engaging in any verbal or written communication about its plans.[9/] Or, the bidder can simply reveal his identity. There is no requirement that the bidder conceal his identity in making a foothold acquisition by purchasing stock anonymously through a street name account. If the bidder is a known raider, the market will react rapidly.

This additional provision might merit study in the context of takeover reform. It is related to the question when a bidder should be required to disclose his identity, and also to the question what constitutes group activities. We do not believe, however, that Congress should adopt this provision as part of an insider trading bill which focuses on a different subject -- the unauthorized use of confidential information.

D. The Definition Should Provide The Exclusive Standards For Determining Whether Use Of Information Constitutes Insider Trading

S.1380 provides that it would provide the "exclusive standards" for determining whether a person's conduct constituted insider trading. The bill provides the SEC with rulemaking

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9/ See, e.g., Sandler, "Heard on the Street: Gerber Products Surges on Takeover Rumors To Levels Some Analysts Consider Too Risky," Wall Street Journal, August 5, 1987, at 49.

authority to ensure that unintended loopholes do not develop which would allow evasion of the prohibition. Further, the bill makes clear that the exclusivity of the provision would not affect prosecutions for manipulation and false statements which violate the law independently of any trading on nonpublic information.

The Advisory Committee reached an identical conclusion, although its exclusivity provision is contained in the preamble to the proposed statute. The Advisory Committee concluded that it would be useless to attempt to define the offense of insider trading unless the definition were exclusive. The new provision would merely become another count in a multiple count complaint, which would include a mail fraud charge, a charge under Section 10(b) and Rule 10b-5, and frequently a charge under Section 17(a) of the 1933 Act.

In short, we support the concept of exclusivity and the other provisions in the bill that are designed to ensure that loopholes do not develop.

III. COMMENTS ON THE SEC'S ALTERNATIVE PROPOSAL

The SEC's proposal represents a step forward, in my view, from its historic opposition to legislation defining insider trading. The SEC's proposal accepts in principle the wrongful acquisition or use standard, attempts to avoid creating a roadblock to the free flow of information, and recognizes that

a definition would not serve a useful purpose unless it were exclusive.

The SEC's proposed definition of insider trading, however, differs in a number of important respects from S.1380 and the definition proposed by the Legal Advisory Committee. I believe that the SEC's approach is unnecessarily complex and unduly restrictive. In several respects, it would create needless impediments to the free flow of information, create great uncertainty, and raise questions of unfairness to those who seek in good faith to comply with the law.

A. Prohibitions on Communications

The SEC proposal would attempt to control the flow of information by creating an absolute prohibition against communicating material, nonpublic information in any context in which it was "reasonably foreseeable" that the recipient would trade on the basis of the information. In order to prevent this prohibition from creating a complete blockage of information, Section 16A(d) of the SEC's proposal then creates a number of vague exceptions.

For example, Section 16A(d)(4) would authorize a corporate officer to communicate information to a "person engaged in the business of analyzing and disseminating information" if the communication was not made for personal benefit -- essentially the Dirks personal benefit standard. Nowhere in the provision, however, is the phrase "business of analyzing and disseminating

information" defined. Does this exception only apply to the financial press? Does it include the financial analyst who works exclusively for a mutual fund or other institutional investor and therefore might not be deemed to be in the business of "disseminating information?" Does it include a broker-dealer who issues research reports only for the benefit of the clients of the firm? If not, why not? Does the person have to be engaged full-time in "the business of analyzing and disseminating information"?

The exception provided by Section 16(A)(4)(A) is troublesome because it errs in the other direction. Would not Winans be exonerated under this provision? The provision provides a safe harbor for communications "in the ordinary course of business by a person engaged in the business of analyzing and disseminating information concerning securities, the markets for securities, or the financial condition of issuers." Under this provision, a financial columnist, such as Winans, might be able to tip his friends that he was about to issue a highly negative opinion about a company without incurring any liability.

Section 16A(d)(3) would create an exception for communications made in a "reasonable effort to make the information public." Precisely what this includes is unclear. In the Dirks case, an Equity Funding employee tipped material, nonpublic information about a fraud at the company to Dirks, a securities analyst, hoping that Dirks would provide it to his clients, that their trading would lead to an SEC investigation,

and ultimately that the information would be made public. Would that conduct be a "reasonable" effort to make the information public? If not, what is the standard of reasonableness and who is to decide the issue?

The vagueness of the SEC's exceptions illustrate the fundamental flaw of its approach -- it focuses on controlling information, rather than on prohibiting wrongful conduct. We agree with the views of former SEC Commissioner Smith that the law should "focus on policing insiders and what they do . . . rather than on policing information per se and its possession, which [is] unpracticable."10/ By controlling information rather than wrongful conduct, the SEC's approach could greatly hinder the free flow of information to our capital markets.

The SEC's approach suffers from another flaw. The SEC's proposal would impose liability upon a person who communicates information if he should have "reasonably foreseen" that the recipient would trade on the basis of the communication. This standard would create potential liability for persons who communicate information for an entirely legitimate purpose and with no purpose or expectation whatsoever that the other party will misuse it. They would be subject to liability if, in hindsight, it were found that it was "reasonably foreseeable" that the information would be misused. Such "in terrorem" liability would severely inhibit good faith communication of investment information. The proper approach is to punish the

10/ In re Investors Management Co., 44 S.E.C. 633, 648 (1971) (concurring opinion).

recipient of the information who abuses a business or personal relationship -- as our proposal and S. 1380 would do -- and not the good faith, but perhaps too trusting, communicator.

In sum, it is essential to the health of our securities markets that we not hinder the free flow of information. The SEC also recognizes this. By focusing on the control of information rather than on the conduct of the communicator, however, the SEC's approach requires the creation of numerous exceptions. It is difficult to create exceptions to insure that the markets are not impaired by its prohibition on communication that are all encompassing without creating loopholes to protect illegal conduct. It is not clear how broad or how filled with holes the SEC exceptions are. We respectfully urge that this approach not be adopted.

B. The Use Versus Possession Tests

Although, at first blush, the SEC's proposed definition appears to focus on misuse of material, nonpublic information, it effectively retreats toward a "possession" standard of liability. In the case of an individual, it provides that mere possession of such information would give rise to an irrebuttable presumption that the information was used in connection with any trading. In the case of an entity, such as a broker-dealer firm, the presumption would be rebuttable but only if the entity could demonstrate that it did not use the information and that it had implemented "reasonable" procedures to prevent insider trading

problems. This would essentially adopt the provisions of Rule 14e-3, which now apply only to tender offer information, and make them applicable across the board to all types of information.

The Legal Advisory Committee considered and rejected the SEC's approach because it would lead to unfair and unpredictable liability based upon hindsight application of vague concepts. The Committee's proposal would create a presumption of use in the case of an individual; however, it would give the individual a chance to prove that he did not, in fact, misuse the information that was somehow in his "possession." The Advisory Committee's proposal, like S.1380, also provides that multi-service firms are presumed to have used material, nonpublic information in their possession when they trade in securities unless they can prove that the trades were not influenced by the information and that the persons responsible for making the trading decisions did not know of the information. The trier of fact is entitled to consider whether the firm has "implemented and maintained" adequate procedures to prevent misuse of information in determining whether the firm has met its burden of proof.

The Advisory Committee agreed to adopt these rebuttable presumptions despite its belief that the defendant would in many cases find it extremely difficult to meet its burden of proof to demonstrate a negative -- nonuse. The Committee understood the concerns that have been expressed regarding misuse of information in multi-service firms and, as a result, agreed with the concept of shifting the burden on the use issue to the defendant.

The Committee was strongly opposed to the concept of making insider trading liability turn on whether the firm has adopted and maintained "adequate" procedures. We believe that this approach is both flawed and fundamentally unfair.

There would be absolutely no guidance in the law, under the SEC's approach, for determining when a firm's procedures are "reasonable under the circumstances" to prevent the misuse of material, nonpublic information. The SEC has recognized that it is not feasible to specify standards which could be used as guides. Instead, each institution must tailor their own policies and procedures to fit their situation. Nevertheless, the SEC proposes that institutions are liable for insider trading if the SEC or a court, using 20/20 vision in hindsight, find that the procedures are not reasonable or adequate in some respect, even though there is proof beyond any doubt that any material, nonpublic information in possession of the institution was not known to the employees engaged in the trading. The fundamental unfairness in this approach is obvious.

Equally troublesome is the fact that the SEC proposal requires no causal connection whatsoever between the inadequacy of an institution's policies and procedures and the trading. Even though the breakdown in the procedures may be unrelated to the trading, the firm is liable for insider trading. Thus, by establishing an irrebuttable presumption, banks, broker-dealers and other institutional investors, especially large multi-service firms, would be liable for trades in that stock by its employees

even if (1) those employees are in a different city or country and had absolutely no contact with other employees in possession of material, nonpublic information regarding the securities being traded, and (2) a defect in its policies and procedures had no relationship with the trading at home.

The SEC's reliance on an irrebuttable presumption of use from mere possession of information by an individual is also troublesome. This is nothing more than a resurrection of the discredited possession theory. Unfortunately, S. 1380 takes the same approach as to individuals.

One can understand why the SEC would like, as an enforcement matter, to have this irrebutable presumption. However, it leads to fundamental unfairness. There are situations where an individual is in "possession" of material, nonpublic information even though that individual did not use that information in his trading decision. For example, if an individual may be deemed in "possession" of material, nonpublic information even though he has nevertheless never seen it, he would be liable under the Commission's definition. Further, if a person places an order for a security but it has not been completed and then the individual receives material, nonpublic information, he would be liable under the Commission's definition once the order has been filled. Finally, if an individual has a stock purchase plan to purchase stock automatically on a regular basis, that person nevertheless would be liable under the Commission's definition even though it is clear that the information was never used in

the purchase of the stock.

Acting Chairman Cox claimed in his June 19, 1987 statement to this Subcommittee that an irrebuttable presumption is necessary to eliminate difficulties in proving cases against individual defendants. To the contrary, a rebuttable presumption such as contained in the Legal Advisory Committee's proposal would only codify what the Commission must almost always prove today. The SEC has been operating under a "use" standard for years, and it has never affected the SEC's ability to prosecute insider trading cases. I am not aware of any case brought by the SEC solely on the basis of possession, without evidence that the defendant in fact misused the information involved.

C. Private Rights of Action

The SEC's reliance on irrebuttable presumptions of misuse stemming solely from possession of material nonpublic information is particularly troublesome because of the severe sanctions that would attach to a violation of its proposed statutory definition. An individual who trades while in possession of such information or a firm which trades while in possession of such information that cannot demonstrate the reasonableness of its policies and procedures would be subject, not only to potential criminal liability, but also to a penalty equal to three times profits earned or losses avoided under the recently enacted Insider Trading Sanctions Act ("ITSA").

The SEC's proposal would subject a person who trades while

in possession of material, nonpublic information to further liability regardless of any evidence of an actual misuse of the information. It would provide two separate statutory causes of action: one on behalf of all persons injured as a result of the violation, and a second on behalf of all contemporaneous traders in the security to which the violation relates. The SEC's proposal places no limits on this civil liability. Presumably, one who traded a mere 100 shares while in possession of material inside information, regardless of any evidence of actual misuse, could face liability for disgorgement of profits to the contemporaneous traders, treble damage liability under ITSA in an action brought by the SEC, and additional unlimited liability to other persons who may have been injured as a result of the trading or communication of information.

Moreover, unlike the provisions of ITSA, the SEC's proposal would provide no protection to innocent employers of persons who violate the statutory definition. If the SEC's proposal were accepted, broker-dealers and other employers could face unspecified liability under principles of respondent superior, which makes an employer, regardless of fault, liable for all activities occurring within the scope of its employee's actual or apparent authority. We submit there is no justification for such draconian exposure, particularly when it could be based on presumptions stemming from mere possession rather than any evidence of actual misuse.

IV. CONCLUSION

Despite our disagreement with certain aspects of S.1380 and the alternative SEC's proposal, we believe that there is a basis in the three proposals -- the SEC's, the Advisory Committee's and the Pitt group's -- for developing a workable, effective definition of insider trading that will maintain confidence in our nation's securities laws. Such a proposal, however, must not depend on irrebuttable presumptions, vague exceptions and unlimited draconian liability.

On behalf of the Advisory Committee, we appreciate the opportunity to participate in this very important process of developing such a definition.

REPORT OF THE NEW YORK STOCK EXCHANGE LEGAL ADVISORY COMMITTEE

PROPOSED STATUTORY DEFINITION OF INSIDER TRADING

At the request of John J. Phelan, Jr., Chairman of the Board of the New York Stock Exchange ("NYSE"), the NYSE Legal Advisory Committee, through its Subcommittee on Tender Offers, has developed a proposed statutory definition of "insider trading" to clarify the circumstances under which trading on the basis of material, nonpublic information should be deemed unlawful. Part I of this report contains a summary of the proposed definition and the considerations which led to its development. Part II of this report discusses the policies that should be served by a prohibition on insider trading and the deficiencies in the present law. Part III contains the proposed definition and a detailed explanation of the way the Committee believes it should operate.

PART I

Introduction and Summary

The Committee believes that the basic policy objective in defining the crime of "insider trading" should be to design a law that protects the integrity of our securities markets, without interfering with the free flow of information into those markets. In the Committee's view, it is essential to maintain honest markets in which corporate officials and other persons are not permitted to trade on the basis of information that has been entrusted to them in confidence for nontrading purposes or that has been obtained by theft, misappropriation, conversion or other improper means. This basic policy objective can and should be achieved without impairing the ability of securities analysts and investors to pursue information by honest means without fear of liability. The Committee believes that the vigorous search for information promotes the long term interests of all investors by ensuring that information flows freely as well as honestly.

The Committee considered a number of proposed definitions, including two that were contained in a Report of an ABA Task Force on the need for legislation to clarify the law (hereinafter "*ABA Task Force Report* at ").[1] Although the Committee concurred with the excellent analysis contained in the *ABA Task Force Report*, it found that neither of the ABA's proposed definitions was entirely satisfactory.

The Committee therefore developed a separate definition drawing upon the best qualities of the two ABA Task Force definitions. During the process, the Committee coordinated its efforts with those of another group, led by former SEC General Counsel Harvey L. Pitt, which was organized at the request of Senator Donald Riegle, to attempt to reach a consensus on the proper definition of insider trading. The Committee and the Pitt Group ultimately arrived at substantially

[1] *Report of the Task Force on Regulation of Insider Trading (Part I: Regulation Under the Antifraud Provisions of the Securities Exchange Act of 1934)*, 41 Bus. Law. 223 (1985).

similar conclusions with respect to the need for, and basic elements of, a new statute. The substantial similarity between the approaches adopted by the two groups is convincing evidence that it is possible to reach a consensus on the basic elements of a statutory definition.

The Committee's proposal, which is set out in Part III of this report, would enhance the government's ability to prosecute insider trading cases without impairing legitimate research and analysis. The proposal would codify and clarify the standards for insider and tippee liability set forth in the Supreme Court's *Dirks* and *Chiarella* decisions.[1] It would also codify the so-called "misappropriation" theory under which "outsiders" can be held liable for trading on the basis of nonpublic, market-sensitive information if they have stolen, misappropriated or converted the information to their own use. However, it would remove some of the impediments which currently restrict the government's use of the misappropriation theory and provide greater certainty for those who seek to conduct their affairs within the confines of the law.

The key provisions of the Committee's statutory proposal are: (1) a broad prohibition against trading by any person on the basis of material, nonpublic information where the use of the information for trading would constitute a breach of fiduciary duty, a personal or other relationship of trust or confidence or a contractual or employment relationship, or where the information has been obtained by theft or conversion; and (2) a prohibition against the communication of material, nonpublic information to another person for the purpose of assisting that person to use the information in violation of the statute. The proposed statute also contains provisions creating a rebuttable presumption of use from possession of material, nonpublic information, providing the SEC with limited rulemaking authority, and ensuring that firms are not held liable without fault for the private trading violations of their employees.

The Committee believes that this proposed statute promotes the policy objective of protecting the integrity of the marketplace, without interfering with the free flow of information. It ensures that wrongful use of confidential information by *all persons* entrusted with such information is prohibited by providing a statutory foundation for the misappropriation theory. Indeed, the statute goes beyond the current misappropriation theory by eliminating much of the archaic fraud requirements which must presently be satisfied to establish an insider trading violation under that theory. The definition accomplishes this by removing the subject of insider trading from the rubric of "fraud" and making it a "wrongful use" of information crime. The primary purpose of the prohibition would be to protect the integrity of our securities markets and not to protect victims of "fraud."

The statute also ensures that the free flow of information is not impaired by avoiding the old possession and selective disclosure concepts. Those concepts served to expose corporate executives and securities analysts to liability if, based entirely upon hindsight judgment, any of the information imparted during their conversations with each other was viewed as being "material"—a concept which

[1] *Dirks v. SEC*, 463 U.S. 646 (1983); *Chiarella v. United States*, 445 U.S. 222 (1980).

Senator RIEGLE. Mr. Phillips, let me just thank you for your testimony and I want to just emphasize what you have just stated, and that is, I take it that the view of the Stock Exchange Legal Advisory Committee is that we do need a clearer definition of insider trading. You've developed a proposal. You've brought it to us today. While there are some differences of opinion between the three proposals now that are on the table, I take it that it's fair to say that you think that it is both in the public interest to find a common version out of these three, and that you think it can be done. Is that a fair statement?

Mr. PHILLIPS. Absolutely, Senator. I do think it is in the public interest and it should be done.

Senator RIEGLE. I'm going to then ask that your organization and the Pitt group represented here and the SEC and others of us who are directly involved move forward in a kind of collective process. It's not exactly clear to me what format that should be in or if it even needs a format because I think all the parties at interest seem to be moving in the same direction, agree on the need to try to reach a consensus if we can.

I think the one thing we've learned so far is that despite the difficulty and the complexity of these issues that would seem at the start to make it almost impossible to get anywhere, that in fact we've gotten a very long way down the road. We've gone through a lot of these things. We've been able to resolve a number of issues. There is I think an emerging consensus. I think there is a common ground that is beginning to reveal itself and I'd like to urge—the proposal that is before the committee is the one that we have presented as certainly some members of the committee. I would like to work within that context. I would like to sort of take that as the point of both beginning and, if you will, then departure; and if we're going to make adjustments, try to make the adjustments off that as a basic model and see if we can do that in a way that can satisfy the SEC for the most part, satisfy the New York Stock Exchange Legal Advisory Committee, and my hope would be that if we approach that issue carefully and thoroughly that we could find a way to narrow these differences and finally resolve them. And that, after all, is the purpose I think of our effort and of the search for good public policy.

I don't think we should be either at the whim of individual court decisions, or whether or not the Supreme Court is going to do this or that in the *Winans* case. I think it's clear on the record that what we have established so far is that everybody would gain if we can complete this process with a clear, tight, workable definition.

And if future events should show us that that law needs refinement, all laws need refinement. We continue to refine the law and we have to refine the law in the future. So we're not writing something for all time. We are writing something for now and as far ahead as we can see.

So I take it then that you would be prepared, Mr. Phillips, on behalf of the committee that you represent to work in that fashion to see if we can't reach that conclusion?

Mr. PHILLIPS. I would be very pleased to.

Senator RIEGLE. Mr. Pitt, let me ask you if your group, likewise, would be prepared, having done a lot of work already, to see if we

was difficult for a lawyer, let alone a layman, to apply in practice [5] by adopting a "wrongful use" standard, the proposed statute would leave room for honest research without creating opportunities for abuse.

The Committee also considered but reached no conclusion regarding whether the Congress should enact a statutory definition prior to the Supreme Court's decision in *United States v. Carpenter*, commonly known as the *Winans* case.[6] If the Supreme Court affirms the Second Circuit's decision in that case with a strong opinion upholding the misappropriation theory, there would be a substantial basis for concluding that current law reaches all conduct that it should reach. The SEC apparently still adheres to this position. Chairman Shad recently stated the "courts are doing a good job of refining the definition" and therefore that Congress should wait until the *Winans* case is decided before acting.[7]

Some Committee members, however, share the widespread belief that, regardless of the outcome of the *Winans* case, the crime of insider trading should be defined with greater clarity. The government has begun to vigorously prosecute such violations criminally, and treble damage penalties are now available under the Insider Trading Sanctions Act ("ITSA") even for civil violations. Further, the misappropriation theory is still relatively underdeveloped, and many gray areas currently exist with respect to the scope of that theory. Under these circumstances fairness requires something more than the vagaries of existing law developed under the general antifraud provisions of the federal securities laws.

Moreover, there is a growing belief that, because the misappropriation theory is oriented to the protection of employers not to participants in the securities markets, it will ultimately lead to irrational and confusing results in the insider trading context. As one practitioner noted,

> Irrespective of whatever the Supreme Court decides [in *Winans*], you need a definition. . . . The misappropriation doctrine is so laden with arcane concepts and artificial dividing lines that the layman couldn't possibly understand what's permitted and what's prohibited.[8]

In any event, it is the consensus of the Committee that the Exchange has a responsibility to respond to the growing Congressional interest in insider trading legislation by proposing a definition at this time. Congress may be ready to act now. Many believe that legislation is inevitable. The Securities Industry Association and other groups have indicated that the time has come for a statutory definition.[9] Indeed, a prominent federal prosecutor recently asked Congress to provide a clearer definition of the crime.[10] By proposing its own definition for

[5] *See SEC v. Monarch Fund*, 608 F.2d 939 (2d Cir. 1979); *SEC v. Bausch & Lomb*, 565 F.2d 8 (2d Cir. 1977).

[6] *United States v. Carpenter*, 791 F.2d 1024 (2d Cir. 1986), *cert. granted*, 107 S. Ct. 866 (1986).

[7] "Demand Rises for Law Defining Insider Trading to Provide More Than a Gut Feeling as a Guide," *The Wall Street Journal*, Mar. 26, 1987, p. 70, col. 3.

[8] *Id.* at 70, col. 4.

[9] *Id.* at 70, col. 2.

[10] "Giuliani Asks Congress to Define Insider Trading," *New York Times*, April 23, 1987, p. D32, col. 1.

consideration by Congress, the Exchange would be able to demonstrate that the crime of insider trading can be broadly and fairly defined without interfering with the free flow of investment information to the marketplace.

PART II

The Policy Choices and the Existing Law

The federal securities laws do not contain provisions that specifically make it unlawful to engage in "insider trading."* Instead, the prohibitions on insider trading have been developed on a case-by-case basis under the general antifraud provisions of the federal securities laws, principally Section 10(b) of the Securities Exchange Act of 1934 ("1934 Act") and Rule 10b-5 thereunder. Because these laws have developed under the rubric of fraud rather than under specific statutes designed to deal with misuse of nonpublic information, they have never provided clear guidance concerning the conduct that is prohibited.

The very term "insider trading" is a misnomer. The insider trading prohibitions apply not only to trading by officers, directors, and employees of a publicly-traded corporation on the basis of material, "inside" information, but also to trading by complete strangers to the corporation on the basis of material, "market" information of which the corporation may not even be aware. The substance of the crime has been trading by any person on the basis of material, nonpublic information under circumstances when, under fraud concepts, he has a duty to disclose what he knows. The issue is and has always been defining the circumstances under which a person with possession of nonpublic information has such a duty. The insider trading laws have been criticized at times as being overinclusive—stifling legitimate activities which should be encouraged—and more recently as being underinclusive—permitting conduct which by any definition falls below the ethical standards that should be required of those using our securities markets.

The development of a proper definition of the offense of insider trading raises three questions: (1) what policies should be promoted by a statutory definition, (2) how is the present law promoting or failing to promote those policies, and (3) how should present law be modified to best promote the policies? We discuss each of these issues below.

A. The Policy To Be Served By Insider Trading Laws

The Committee has reached a clear consensus on the basic policy that should be served by an insider trading definition. The Committee agreed that the definition should ensure that no one is permitted to trade in our securities markets on the basis of material, nonpublic information that has been entrusted to him or her for legitimate nontrading purposes or that he or she knows has been obtained by theft, misappropriation or other improper means. The Committee further agreed that the definition should not chill a vigorous search for information by securities

* Section 16(b) of the Securities Exchange Act of 1934 does deal with insider trading, but it does not prohibit it or even define it. It provides for recovery of profits realized from "short swing" transactions by corporate officers, directors, and 10 percent beneficial owners as a means of reducing the opportunity for these insiders to trade on the basis of insider information.

analysts, shareholders, and investors who probe corporate managers with questions that go behind the disclosures in financial and other reports.

Despite the disclosure requirements of the federal securities laws and the Exchange, there are frequently occasions during which publicly-traded corporations may legitimately delay the disclosure of market-sensitive information. Corporations may delay reporting information in order to protect a valuable business opportunity. They may also do so merely to verify the accuracy of the information. The reporting of information which later turns out to be inaccurate frequently results in costly "fraud on the market" lawsuits against publicly-held corporations based upon claims that the corporate managers knew or had reason to know that the information was inaccurate. Since some delay is almost inevitable, by necessity corporate officials and others must be entrusted with nonpublic information until it can be made available in press releases or in SEC filings.

The insider trading doctrine has been founded on the need to preserve investor confidence in the market. That confidence is undermined when investors come to regard the market as a "rigged" game because corporate insiders and others who are entrusted with valuable, nonpublic information use that information for their own trading purposes. The *ABA Task Force Report* concluded that the traditional premise for an insider trading prohibition is as valid today as it ever has been. It noted that, although it cannot be proved empirically, "common sense" supports the view that "people will not entrust their resources to a marketplace they don't believe is fair, any more than a card player will put his chips on the table in a poker game that may be fixed."[10]

The insider trading doctrine has also recognized that there is an important interest in preserving the ability of investors to ferret out information by honest means. In our markets, this investigative function is primarily delegated to professional securities analysts.[11] These analysts meet with corporate officials, ask them questions that seek to go beneath the surface of reported information and form judgments as to the investment worth of corporate stocks. The analysts sometimes find that the quality of the reported earnings or assets is not as good as they seem on the surface, and they report this. Sometimes, as in the *Dirks* case,[12] they discover more serious problems. In either case, they perform a valuable function which furthers the full disclosure policies of the federal securities laws. They can continue to perform this function only if they are not inhibited from using information honestly obtained through their own efforts on behalf of the clients to whom they provide investment management and advisory services. As a necessary corollary, analysts cannot function if honest corporate executives are reluctant to speak for fear that, based entirely on hindsight, the SEC will argue that they violated the law by letting something "material" slip out.

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[10] *Id.* at 227.

[11] *See Dirks*, 463 U.S. 646; *Teamsters Local 282 Pension Trust v. Angelos*, 762 F.2d 522, 527 (7th Cir. 1985) ("In liquid capital markets investment bankers, arbitrageurs, and other professional investors serve [an] investigative function. Their discoveries affect the price of the securities and bring that price closer to the one that is accurate in light of all available information. *Dirks* shows this process at work.").

[12] *Dirks*, 463 U.S. 646.

Despite disagreement as to the proper means of doing so, there is general agreement that the insider trading laws should not discourage analysts from performing research through honest and legitimate means. The Supreme Court's decision to set aside the sanction in the *Dirks* case was premised in part upon the conclusion that a sanctioning of Raymond Dirks for reporting the Equity Funding fraud to clients would have an "inhibiting influence on the role of market analysts. . . ."[13]

Indeed, the SEC itself, despite its censure of Mr. Dirks, has recognized that the insider trading laws should not discourage securities analysts from pursuing corporate information. The SEC explained that "[t]he value to the entire market of [analyst's] efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by [their] initiatives to ferret out and analyze information, and thus the analyst's work redounds to the benefit of all investors."[14] In sum, although there was disagreement over the proper means of doing so, there was no disagreement in the *Dirks* case that the role of the analyst should be protected as a matter of policy.

B. Why Current Law Is Inadequate To Serve The Policy That Should Be Served

There is also a growing belief among members of Congress, securities practitioners, and the general public that the insider trading laws are inadequate to serve the basic policy interest that they should promote. The problems with the insider trading rules, as they have evolved, are set forth in the *ABA Task Force Report*.[15] We summarize these inadequacies below.

1. *The Possession Theory*

Until the Supreme Court's well-known decisions in *Chiarella* and *Dirks*, the SEC and the courts had developed a fairly simple insider trading rule under the antifraud provisions of Rule 10b-5—anyone in possession of material, nonpublic information owed a duty of disclosure to the persons with whom he traded. As the Second Circuit put it in the *Texas Gulf Sulphur* decision:

> [A]nyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it . . . , or he chooses not to do so, must abstain from trading or recommending the securities concerned while such information remains undisclosed.[16]

The duty to disclose such information was based upon the "inherent unfairness involved where [any] party takes advantage of information knowing it is unavailable to those with whom he is dealing."[17]

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[13] *Id.* at 658.

[14] *In re Raymond Dirks*, 21 SEC Docket 1401, 1406 (1981).

[15] 61 Bus. Law. 223. *See also* Phillips & Zutz, *The Insider Trading Doctrine: A Need for Legislative Repair*, 13 Hofstra L. Rev. 65 (1984).

[16] *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

[17] *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961).

The possession standard was first applied to corporate insiders and their tippees. But, by its very logic, it was applicable to trading by complete strangers with access to nonpublic information concerning the market for a corporation's securities. Thus, eventually, the possession theory was applied to outsiders with possession of so called "market information," i.e., information relating to the market for a company's securities rather than its internal operations.[68]

The problem with the "possession" theory from a policy perspective was that it reached too far. It failed to distinguish between information advantages which were obtained honestly by hard work, skill, or luck and those which were obtained dishonestly through misappropriation, theft or breaches of confidential relationships. It made it extremely dangerous for corporate insiders and analysts to discuss corporate affairs with each other. The insider could be held responsible as a "tipper" and the analyst as a "tippee" if, based upon hindsight, any of the information conveyed was viewed as being material and nonpublic. As one court noted, analysts were forced to "act at their peril" in making inquiries and reporting their findings to their clients.[69] Finally, it made it difficult for insiders to engage in legitimate purchases or sales of stock in their companies because the law was (and still is) unclear as to the definition of "materiality" in the insider trading context and whether the insider must be motivated to trade "on the basis of" the information or whether mere "possession" is enough for liability.[70]

2. *The Fiduciary Duty Theory*

In *Chiarella* and *Dirks*, the Supreme Court rejected the possession theory and replaced it with a "fiduciary duty" theory. The Court held that a duty to disclose information "arises from the relationship between parties . . . and not merely from one's ability to acquire information because of his position in the market."[71] Thus, trading on the basis of nonpublic information cannot constitute "fraud" within the meaning of Section 10(b) in the absence of a "relationship of trust and confidence between the parties to a transaction" which imposes a duty to speak.[72]

The Court's fiduciary duty theory prohibits misuse of nonpublic information in many of the traditional "insider trading" contexts. First, it prohibits the true insiders—i.e., corporate officials—from converting to their own use information which is entrusted to them for corporate purposes. The Supreme Court pointed out that corporate officers and directors have a fiduciary duty to their shareholders which requires them to disclose material, nonpublic information before trading in the stock of their companies.[73]

Second, the fiduciary duty theory applies to "constructive insiders"—outsiders who are entrusted with nonpublic information during the course of their work for the corporation

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[68] *United States v. Chiarella*, 588 F.2d 1358 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980).

[69] *SEC v. Monarch Fund*, 608 F.2d at 988.

[70] 41 Bus. Law. at 232 n.21.

[71] *Chiarella*, 445 U.S. at 231 n.14.

[72] *Id.* at 230.

[73] *Id.* at 229-233.

> *Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders.* The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes. . . . For such a duty to be imposed, however, the corporation must expect the outsider to keep the disclosed nonpublic information confidential, and the relationship at least must imply such a duty.[74]

Thus, the fiduciary duty theory prevents attorneys, accountants, underwriters, and other confidential corporate consultants from misusing confidential information entrusted to them for corporate purposes.

Third, the fiduciary duty theory also reaches "tippees" when their insider sources "personally benefit" directly or indirectly from the disclosure of nonpublic information and the tippees know or have reason to know of this fact.[75] In such circumstances, tippees become "participants after the fact" in the breach of fiduciary duties owed to shareholders and thereby assume the fiduciary obligations of their insider sources. Absent personal gains from the disclosure of confidential information, however, under *Dirks* and *Chiarella* the insiders do not violate their fiduciary duties to shareholders and the tippees do not assume any duty not to trade on information.[76]

While the *Chiarella-Dirks* fiduciary duty theory prohibits misuse of confidential information in a variety of situations, it is inadequate, in certain types of "outsider" trading situations, to serve the policies that should be promoted by an insider trading prohibition. Attempting to fit the entire law of "insider trading" within a common law fiduciary duty construct leaves large gaps in what should be prohibited conduct. The Supreme Court itself acknowledged that the fiduciary duty theory creates "analytical difficulties" in policing misuse of information by outsiders and that it may result in the legalization of some trading which "may fall below ethical standards of conduct."[77]

For example, corporate insiders may, for proper corporate purposes, entrust confidential information to "outsiders" who are not working for their companies and who are therefore not "constructive insiders" as defined by the Court. Material, nonpublic information may be conveyed for legitimate nontrading purposes in the context of merger and commercial negotiations, in connection with efforts to obtain bank or other financing, as well as in the context of normal social relationships. An insider may convey inside information in trust and confidence

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[74] *Dirks*, 463 U.S. at 655 n.14 (emphasis supplied).

[75] *Id.* at 659-664.

[76] The Court's analysis was based upon common law fiduciary principles. Where a fiduciary communicates confidential information to a third party in breach of his fiduciary duty and the third party is aware of this breach, the common law makes the third party a constructive trustee of the information subject to the same fiduciary duties as his source. 463 U.S. at 660 n.20.

[77] *Id.* at 655, 661 n.21.

to a friend or relative for purposes of obtaining advice or merely as p[illegible] of their normal social dialogue.

The fiduciary duty theory does nothing to prevent outsiders who receive confidential information in such contexts from converting the information to their personal use. In such situations, the insiders breach no duty in disclosing the information, and thus the recipients of the information do not assume the insiders' fiduciary obligations to shareholders. Indeed, the Supreme Court noted one such case in its opinion in *Dirks*.[78]

Further, the fiduciary duty theory fails to reach most types of misuse of market information. The fiduciary duty theory would not prohibit a person from profiting on the basis of information about a tender offer which has been obtained from the bidder by theft, misappropriation or other improper means. In short, the fiduciary duty standard of *Chiarella* and *Dirks* leaves significant gaps in the regulation of nearly all persons who are not "insiders" of the corporation whose shares are being traded.

The *Dirks* personal benefit test, however, is clearly superior to the possession standard in terms of protecting the insider and the analyst who engage in an honest dialogue as part of legitimate research activities. Such persons no longer need communicate at the peril that hindsight judgments as to the materiality or nonpublic nature of information may result in criminal prosecutions or civil fines or judgments. Indeed, the Supreme Court appears to have adopted the personal benefit test in part for precisely this reason. The analyst is free to use any information obtained during research unless he knows that his insider sources are "personally benefiting" from the disclosures.

However, there is still a level of uncertainty. The Supreme Court did not define the circumstances in which an insider will be viewed as "personally benefiting" from a disclosure of information. The Court noted that an insider personally benefits from a disclosure if he receives a "pecuniary gain."[79] This creates no problem. If an analyst bribes an insider with money or agrees to split profits on tips, the analyst and the insider are clearly engaging in unlawful conduct and should be punished.

But, the Court also noted that an insider personally benefits from a disclosure if it results in a "reputational benefit that will translate into future earnings" or if the insider selectively discloses information to a "friend" as a "gift."[80] Precisely what these statements mean is yet to be determined. At the least, they open the door to creative prosecution theories regarding who is a "friend" and what constitutes a "gift" or a "reputational benefit." If these tests are expansively interpreted, corporate executives and analysts again could be placed in the position of "acting at their peril" when they engage in dialogue during honest research. As the Supreme Court itself noted, "determining whether an insider personally benefits from a particular disclosure" is a question of fact which "will not always be easy" to decide."[81]

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[78] 463 U.S. at 662 n.22, discussing *Walton v. Morgan Stanley & Co.*, 623 F.2d 796 (2d Cir. 1980).

[79] *Dirks*, 463 U.S. at 663.

[80] *Id.* at 663-664.

[81] *Id.* at 664.

1. *Rule 14e-3, Misappropriation, and Other Stopgap Theories*

The SEC and the lower courts have attempted to fill the gaps left by *Chiarella* and *Dirks* through a number of stopgap measures. The SEC has adopted Rule 14e-3, which applies to tender offer information, and also has advanced creative new theories of "fiduciary" fraud under Section 10(b). Each of these stopgap measures has its own problems, and ultimately may be declared invalid by the courts. However, even if they have validity, they present a "patchwork" system which is not always consistent and thus is inadequate for counseling to prevent violations or to warn actors that they may face severe criminal liability for their actions.

The SEC's first step to plug holes was the adoption of Rule 14e-3. This rule makes it unlawful, once substantial steps to commence a tender offer have been taken, for any person to trade in securities of the target company if he has possession of information about the tender offer and he has reason to know that it came directly or indirectly from the bidder, the target company, or any employees or advisers working for these companies. Rule 14e-3 effectively reinstates the "possession" standard with respect to trading on material, nonpublic information regarding tender offers.

There are several flaws in Rule 14e-3. First, the rule only applies to "tender offers." Despite the recent focus on insider trading in the context of tender offers, only a minute fraction of mergers and acquisition activity consists of tender offers.[11] Thus, if two companies follow a more common approach and structure an acquisition as a merger, the rule has no application. Thus, the rule's application, even with respect to corporate acquisitions, is incomplete. Second, there is doubt whether the rule is valid. Rule 14e-3 was adopted under Section 14(e) of the 1934 Act, an antifraud provision which the SEC believes could be interpreted to provide it with more rulemaking authority than Section 10(b). However, the Supreme Court has indicated that Section 14(e) is, like Section 10(b), limited to preventing "fraud" and not merely unfairness.[12] Finally, the broad reach of the rule raises a number of difficult issues for investors. For example, are investors engaging in illegal activity when they trade on the basis of market rumors about a possible tender offer? Do they have "reason to know" that this information originated with the bidder or target? Is the information "nonpublic"? Rule 14e-3 provides no guidance concerning these basic issues.

The SEC's second step to plug the holes left by *Chiarella* and *Dirks* was the adoption of the so-called "misappropriation theory" of liability for Section 10(b) liability. The misappropriation theory does not focus on whether any investors have been defrauded or even harmed. Rather, it focuses on the harm that is caused to the owner of information when it is stolen or misappropriated and used in trading securities. The SEC and federal prosecutors have argued with success that the owners of misappropriated information are being defrauded and that this fraud is sufficiently connected with securities trading to constitute a violation of Section 10(b). Frequently, however, the SEC and prosecutors must rely on novel

[11] For example, tender offers accounted for only 3.8 percent of all completed deals in 1985. Austin & Mandula, *Tender Offer Update*, Mergers & Acquisitions 55 (July/August 1986).

[12] *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1 (1985).

damage theories in order to make the misappropriation theory work because the owner of the information suffers no perceptible harm from the use of the information. For example, in the *Winans* case pending before the Supreme Court, the government argued that trading on nonpublic information relating to the *The Wall Street Journal*'s "Heard on the Street" column violated Section 10(b) because it sullied the reputation of that newspaper.[46]

The misappropriation theory is subject to numerous criticisms. First, it is difficult to reconcile the theory with the holdings of *Chiarella* and *Dirks* that there must be a duty owed to an *investor* before trading on nonpublic information constitutes fraud under Section 10(b). Nevertheless, the Supreme Court might affirm the theory as applied to the facts in *Winans* because of the significant role of *The Wall Street Journal* in the dissemination of information affecting securities. It has decided to review the *Winans* case, and certain members of the Court have indicated that they might accept some form of misappropriation theory.[47]

Second, many people believe that the misappropriation theory focuses on matters which are irrelevant to the securities laws. These views are well expressed in the dissenting opinion of Judge Miner in the *Winans* case:

> While the proscription of fraudulent and deceptive practices in connection with the purchase and sale of securities is a broad one, it was never intended to protect the reputation, or enforce the ethical standards, of a newspaper.
>
> It seems especially ludicrous for the government to contend that the court should enforce the Wall Street Journal's conflict of interest policy prohibiting employees from trading on the basis of prepublication information while conceding that the Journal itself is not prohibited from trading on such information. Harm to reputation, rather than to securities markets or market participants, never has been recognized as a proper subject for redress under Section 10(b) or rule 10b-5.[48]

In short, the focus of the federal securities laws should be on protecting investors and confidence in the integrity of the securities markets, not on protecting the proprietary rights or ethical codes of a trader's employer.

Third, the misappropriation theory raises a number of definitional problems. Some states have statutes which make it unlawful to steal or misappropriate certain kinds of information. But others do not. Further, in some states an agent is responsible civilly for misappropriating his principal's property when he personally profits from the use of nonpublic information acquired in the course of his duties. However, in many states there is not even a civil wrong committed by

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[46] *Carpenter*, 791 F. 2d at 1024.

[47] The misappropriation theory was suggested by Chief Justice Burger as a basis for affirming Chiarella's conviction. *Chiarella*, 445 U.S. at 239-245. Several members of the Court indicated that such a theory might have validity, but could not be used in Chiarella's case because the theory had not been presented to the jury. *Id.* at 237-238 (Stevens, J.); *id.* at 238-239 (Brennan, J.); *id.* at 245-252 (Blackmun and Marshall, JJ.). *See also Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299 (1985).

[48] *Carpenter*, 791 F. 2d at 1037.

the agent unless he is depriving his principal of an opportunity."[7] Thus, in the absence of a federal statute making it a crime or at least, as in *Winans*, a specific contractual agreement not to use information, the question whether the misappropriation theory applies in a particular case could be an extremely complex question to answer.[8] As one practitioner commented, the misappropriation theory is "so laden with arcane concepts and artificial dividing lines that the layman couldn't possibly understand what is permitted and what is prohibited."[9]

Finally, in addition to Rule 14e-3 and the misappropriation theory, the SEC has advanced a number of creative duty theories in an attempt to hurdle over the *Chiarella* and *Dirks* limitations. It has argued that recipients of confidential information can become "temporary insiders"[10] even if they are not in a confidential relationship with a corporation and that a newspaper reporter is a fiduciary of the persons who buy the newspaper and read his column.[11] In many of these cases, the conduct is wrongful and should be prohibited. However, the SEC's arguments may be inconsistent with *Chiarella* and *Dirks*.

PART III

The Committee's Proposed Definition

The Committee concurred with the conclusion of the *ABA Task Force Report* that the subject of "insider trading" should be removed from the fraud provisions of the federal securities laws and covered by a new provision dealing with "misuse" of nonpublic information in our securities markets. This would provide a uniform set of laws, rather than the multiple theories under which trading currently might be improper. It would also allow the law to focus on the problem of informational advantages which are obtained improperly or unlawfully, and thus destroy confidence in the integrity of the markets, rather than on matters extraneous to the markets such as protecting an employer's reputation. Finally, it would provide needed clarity for those who are attempting to conform their conduct to the law.

The Committee recommends the following statutory proposal for prohibiting the wrongful use of nonpublic information. The statute would be an addition to Section 16 of the Securities Exchange Act.

Section 16A. Proscriptions Against The Wrongful Use of Nonpublic Information

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[7] For this reason, a corporation has no right of action against an officer or director for "insider trading" in many states. *See, e.g., Brophy v. Cities Services Co.*, 31 Del. Ch. 241, 245, 70 A.2d 5, 8 (1949); *Freeman v. Decio*, 584 F.2d 186, 196 (7th Cir. 1978); *Scheim v. Chasen*, 113 So.2d 739, 746 (Fla. 1975). *See also* Bradley & Clark, *A New Look At Corporate Opportunities*, 94 Harv. L. Rev. 997, 1014-15 (1981).

[8] *See generally*, Kimel, *The Inadequacies of Rule 10b-5 to Address Outsider Trading by Reporters*, 38 Stan. L. Rev. 1549 (1986).

[9] "The Demand Rises for Law Defining Insider Trading," *supra*; *The Wall Street Journal*, Mar. 26, 1987, p. 70, col. 4.

[10] *SEC v. Lund*, 570 F. Supp. 1397 (C.D. Cal. 1983).

[11] 41 Bus. Law. at 236 & n.41.

(a) [Congressional Findings] The Congress finds that—

(1) The fairness, honesty and integrity of the nation's securities markets are undermined when material, nonpublic information is wrongfully used in connection with securities transactions.

(2) Effective prohibitions against the wrongful use of nonpublic information need not and should not discourage the prompt, unfettered flow of information to the securities markets.

(3) The specific delineation of what constitutes the wrongful use of material, nonpublic information is desirable to promote greater clarity in the law and to provide the exclusive statutory standards by which such conduct shall be assessed and, where appropriate, redressed, under the federal securities laws.

(b) [Prohibitions Against The Wrongful Use of Material, Nonpublic Information]

(1) It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facilities of any national securities exchange, or of any automated quotations system maintained for the trading of securities,

(i) knowingly or recklessly to use material, nonpublic information to purchase or sell any security if such information has been obtained wrongfully, or if the purchase or sale of such security would constitute a wrongful use of such information, or

(ii) to communicate material, nonpublic information for the purpose of assisting another person to wrongfully use such information to purchase or sell any security in violation of this Section.

(2) For the purposes of this Section, information shall be deemed to have been used or obtained wrongfully only if it has been obtained by, or its use would constitute theft, conversion, or a breach of a fiduciary duty, a personal or other relationship of trust and confidence, or a contractual or employment relationship.

(3) For the purposes of this Section, any person who purchases or sells a security while in possession of material, nonpublic information relating to that security will be presumed to have used that information in connection with such person's purchase or sale of the security, unless that person sustains the burden of proving that—

(i) the purchase or sale of the security was not influenced by such material, nonpublic information, and

(ii) in the case of a person other than a natural person, individuals participating in the decision to purchase or sell the security on behalf of such person did not know the material, nonpublic information. In determining whether any person other than a natural person has sustained its burden of proof under this subsection,

can't—I think we've maybe come 75 yards down the field here out of one end zone headed for the other. Would it be your view that you and your group would feel that we can continue now in an intense way to try to see if we can't resolve these differences and try to come up with a single version?

Mr. PITT. Yes. I think we would be delighted to participate in that effort and see this through to a successful conclusion.

Senator RIEGLE. Very good. I'm going to pose a couple of questions in the remaining time that I have.

Let me just ask you first, Mr. Pitt, what do you believe is the principal effect of the Commission's omitting the misappropriation and conversion theory from their proposal and how serious a flaw do you think that omission is?

EFFECTS OF OMITTING MISAPPROPRIATION AND CONVERSION THEORY

Mr. PITT. I think it's a serious flaw for several reasons. One is that basically misappropriation and conversion have some defined terms at the moment that can be built upon in the case law.

Second, I believe that the breach of duties that Mr. Cox and Mr. Lynch referred to are not a complete substitute for conversion and misappropriation. The theory is more along the lines that Mr. Phillips is indicating. I get information for one purpose, I use it for another. To have to struggle to find duties that the courts have never even considered strikes me as being unwarranted.

Third, I believe that if a statute were to pass now, irrespective of what happens in Winans, no matter how we change the legislative history, that omitted the concepts of misappropriation and conversion, there would be people who would argue that that meant we had cut back on those theories. And I think that would be a mistake.

Senator RIEGLE. My time is up and I do have some additional questions that it's very important that we pose and get answers on the record. Senator Bond.

Senator BOND. Mr. Chairman, with apologies, I want to ask this distinguished panel to go back to some basic principles. We've made 75 yards down the field. I would just like to have the views of the panelists of whether we are on the right field.

Professor Rogers of the Columbia University Graduate School of Business has expressed a view that I think we probably have seen in perhaps Wall Street Journal editorials. He says in a June 7 article in the Washington Post:

> Most of the problems with the so-called insider trading result from too much Government regulation already. More regulation will aggravate, not alleviate, the problem. Part of the problem is that it's impossible to define inside information. It cannot be done without destroying the securities markets as we know them because any attempts to describe in broad terms what the law demands for definition inevitably will make illegal what most agree are proper activities.

Finally, he says:

> The answer is simple. Repeal the Williams Act, enforce the laws on full disclosure, enforce the laws on theft, fewer laws will help solve the problem. Adding new ones could make it worse.

Gentlemen, would you care to comment on that?

Mr. OLSON. I would observe that college professors often think that things are simple until they are elected to political office or

appointed to judicial position and then they find that they are considerably more difficult than they thought when they were writing articles.

I just think he's wrong.

Mr. PITT. I think it's beyond that. The notion of regulation here really misses the point. We are not talking about regulation. We are in effect talking about enforcement. This isn't a system of Government regulation that we are posing. We are simply articulating standards that already exist and I daresay that most people would prefer to see those standards articulated than have them developed in a case-by-case basis the way they have been to date.

Beyond that, the notion that theft and bribery can deal with the problem completely I think bears at least some note. Mr. Phillips in his statement refers to the *McNally* case in the Supreme Court and I would commend that to the subcommittee's attention. It's highly doubtful that some of these theories of theft will work on intangible and in any event this Congress and this subcommittee have an opportunity to make the law very, very clear so that the courts won't have to guess what the intent is.

Mr. LEVINE. Senator Bond, you've heard about 2 hours of discussion today about a definition and a rule. You really have to look at it from the SEC's perspective. They are the Government's law enforcement agency that has done a magnificent job in dealing with no statute and you want them to continue to do it because there is a real problem. There's a real problem that has been identified and if you read the newspapers and we step back from our clients and our constituencies to really look at it from what is best for the public interest, they need a plain English definition and they need one that gives them enough flexibility to deal with the unknown as well as the known, and they need to have it now because you can't run the risk in a Government law enforcement agency to roll the dice based on what the Supreme Court will do when it's within the reach.

In terms of addressing a specific question, no one in this room, if we had time to do hypotheticals, would not agree on 80 percent of the hypotheticals because it's what I call the blatant, clear conduct. And having spent 14 years doing this at the agency and now in private practice, it is clear—no one will argue about. What we're really talking about are the fringe, how far it should go, and believe me it's a struggle that's not easy. There is no right answer. It is one where you get the best judgments of good intentioned people.

But you can get those lines drawn and it should be done now and the editorial or the article you referred to is someone who is bringing a much different vantage point to the process than I think Congress should.

Mr. OLSON. I read that article, to be more serious than my first response, when it appeared in the Post. The hypothesis Professor Rogers seems to be that we created opportunities for insider trading by regulating tender offers. That simply isn't true and that's why I said that he's wrong.

We had a lot of insider trading cases around before we had the Williams Act. We had Katy Roberts. We had Texas Gulf Sulphur. We had all of the developing law which led to this theory being accepted by the courts in place before the Williams Act was enacted.

The problem of abuse of access to information which is given for a purpose of trust and confidence and then used for personal profit has been with us for a long, long time and to say that we ought not to do anything about that I think is just bad public policy.

Mr. PHILLIPS. Senator, the Legal Advisory Committee of the New York Stock Exchange is hardly a group of regulatory advocates. They consist of general counsels of the major corporations, senior partners of major law firms, and distinguished academics. These lawyers, corporate and securities lawyers mainly, are very conservative, very concerned with the preservation of private enterprise and the freedom of private enterprise to innovate. Nevertheless they strongly believe that a strong insider trading prohibition is essential to preserve investor confidence in the marketplace because they know that without investor confidence, there is no marketplace.

Senator BOND. Thank you, Mr. Chairman. I think we've got an answer to the question.

Senator RIEGLE. Yes, we have and let me just say, Senator Bond, I think that was an important question. I think the responses are some of the most important we've had today and I think it lays it right square on the line and I think it's very helpful.

Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Mr. Pitt and Mr. Olson and I have talked before and we've exchanged information back and forth for several weeks now. I do want to get into some of the basic questions that I raised before, and that's regarding the presumption of use.

Are either one of you familiar—and I read your memo to me and your letter—of the case of *Francis* v. *Franklin* in the Supreme Court of the United States in 1985? You didn't send it to me, but it says basically:

> A mandatory rebuttable presumption does not remove the presumed element from the case if the State proves the predicate facts, but it nonetheless relieves the State of the affirmative burden of persuasion on the presumed element by instructing the jury that it must find the presumed element unless the defendant persuades the jury not to make such a finding. A mandatory rebuttable presumption is perhaps less onerous from the defendant's perspective, but it is no less unconstitutional.

This was Justice Brennan in the case. I've got a copy of the opinion here. This is why I raised some of those questions earlier, as Mr. Olson and Mr. Pitt know, and you have suggested a revision to the original bill that has been introduced. You were here earlier when the counsel and acting chairman of the Securities and Exchange Commission brought that up.

I still have a problem of any presumption, and I know you've done some work on that and the Court I think said this, and I'll quote the Supreme Court again in *Francis* v. *Franklin*:

> A mandatory rebuttable presumption does not remove the presumed element from the case if the State proves the predicate facts, but it nonetheless relieves the state of the affirmative burden of persuasion on the presumed element by instructing the jury that it must find the presumed element unless the defendant persuades the jury not to make such a finding. A mandatory rebuttable presumption is perhaps less onerous but it's still unconstitutional.

Mr. Pitt, I'd like to hear your comments.

Mr. PITT. Let me say first of all——

Senator SHELBY. Are you familiar with that case?
Mr. PITT. Yes.
Senator SHELBY. You didn't cite that.

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Mr. PITT. No, because we cited a group of cases that we think supported the argument that we don't think we should rely on that. That is to say, we are very close to your position. We think that the Government might well sustain an objection here because what's really been done is to create an affirmative defense to a statute.

Nevertheless, we agreed with you that there was a sufficient question that it oughtn't to be risked. There is no longer in the formulaton we've now proposed any presumption. There is in essence a definition of what the crime is and then there are affirmative defenses. And while I understand Dick Phillips' objections to that and that always makes me think not just twice but 10 times about it because his judgment is so sound, I think what we have done here solves the problem and I'd like to explain it.

In essence, the problem in all of these cases is a question of whether or not the Government in any way, shape or form is relieved of its burden of proving the predicate elements for a crime. The way you solve the kind of difficulty that you have correctly raised is by making sure that the predicate acts are clearly defined. Here, they would be two things.

One would be that you possess material nonpublic inside information; and, two would be that you trade on that information if the use of the information would be wrongful, as defined in the statute.

Then what happens is, so the Government's case is all made out. The Government gets no benefits from any presumptions or anything of the sort. They have to prove that you had the information, that you got it wrongfully, and then that you traded. They don't have to prove, in the case of an individual or even in the case of a corporation, but I'll come back to that, that you relied on the information when you made the trade. All they have to do is prove you got it wrongfully and there is a clear criminal element in that aspect.

Now you turn around and you say, "If I'm willing to concede those points, that is in effect in the old rubric, I demur." I agree that you have made out your prima facie case. I have consented to the predicate elements of a crime. But now the statute says, "I have an affirmative defense if I'm an institution, which is that in an institutional environment I didn't use the information." The crime has been admitted, but I've got an affirmative defense.

That is exactly the way the Federal securities laws and the 1933 act operate where the predicate acts for a crime are you sell securities and they're not registered. Then you can come back in and say, "Well, I admit I did those two things, but I have an affirmative defense. And that is that I had an exemption from the statute." That is exactly the way we patterned that and that has been upheld constitutionally in the *Custer-Channel-Ling* case that I cited to you.

The difficulty that Mr. Phillips cited with an individual, in my view, is not a difficulty for this reason. It is very difficult for any individual who can be said to have wrongfully obtained the information—and I want to stress that that's a critical element of this—that is, that the individual got the information wrongfully, then to turn around and say, "Well, I've compartmentalized my own mind and even though I know the information and even though I got it wrongfully, which implies an element of mental intent, I didn't use it." That is almost inherently unbelievable and while there might be some rare cases in which somebody might be able to compartmentalize their mind like that, we think the courts will deal with those cases equitably and that we don't need to deal with that in the statute.

Senator SHELBY. Mr. Olson.

Mr. OLSON. I would just underline what Mr. Pitt said in responding to Mr. Phillips' concerns about the possession standard. I think Mr. Phillips, for whom I also have the greatest respect and I should say he's the progenitor of all of these efforts because he appointed the task force 2 years ago that started this effort—but his example just wouldn't be caught by either the SEC statute or S. 1380.

If you simply had information in your files or had it on your desk and you didn't obtain it wrongfully and you didn't use it wrongfully, possession wouldn't be a crime. Possession has to be accompanied by that other element of wrongful obtaining and the wrongful use and that is true in both S. 1380 and the SEC bill, and that's what Mr. Phillips I think has overlooked in his statement.

That's also, as Mr. Pitt has said, why there must be an element of criminality and it must be proven by the Government—it doesn't get there by presumption—before anybody can be convicted, and I think, Senator Shelby, that it does respond to the concern you've raised.

As to the point you've made with respect to the *Franklin* case, all I can say is we surrender. You're right and we've changed the bill.

Senator SHELBY. Mr. Phillips, do you have a comment on this?

Mr. PHILLIPS. Yes. I do not read either the SEC bill or S. 1380 to require as a prerequisite for application of a possession test a finding of wrongful acquisition. Clearly that's not in the original S. 1380 bill. I read the change that was made or suggested by Mr. Pitt to replace the irrebuttable presumption with a possession test as a distinction without a difference, a change in semantics that doesn't change one iota the Government's burden or lack of burden in establishing guilt.

Senator SHELBY. Beyond a reasonable doubt?

Mr. PHILLIPS. Beyond even quite clearly convincing evidence or a preponderance of the evidence. The Government shows possession. The Government shows trading. Ergo, guilt.

Now perhaps if Mr. Pitt intended that proof or wrongful acquisition be also an element of the crime, perhaps by some drafting we can resolve our differences and then I think we would perhaps get to a point where the use of a possession test would be acceptable.

Mr. PITT. May I just clarify for the record, I do want to read the language that's in the statute because it makes it clear, and this is in the original as well as in our——

Senator SHELBY. Is this in the current statute?

Mr. PITT. It's in S. 1380 proposed and it's in our proposed revision. It says, "If such person knows or is reckless in not knowing that such information has been obtained wrongfully or if the purchase or sale of such security would constitute a wrongful use of such information." It's right in the statute as proposed now and as we would propose to amend it to have wrongful use as part and parcel of the element.

Senator SHELBY. The whole element, though, of the burden of proof is what I'm trying to keep bringing out and we've had some conversations back and forth that there should not be a presumption. Second, the burden of proof should never shift in any way.

And, Mr. Chairman, I've got a number of questions that I would like to share with both Mr. Phillips and Mr. Olson and Mr. Pitt and Mr. Levine that I want to clarify because when we draft this legislation we want to draft it right and as airtight as we can, and if it's open to constitutional challenges in any way, whether you agree or I agree or he agrees or disagrees, that's what makes a big case in the U.S. Supreme Court. And you gentlemen know that well.

Mr. Chairman, I appreciate your indulgence on my time, too.

Senator RIEGLE. Senator Shelby, let me just say I appreciate the keen interest that you have taken in this and also the leadership you've given on this point because already it's produced I think constructive results and presumably can continue to do so. So I very much support the efforts that you're making and I think if we work together, we ought to be able to find a way to resolve that issue and I think it's important that we get it resolved.

Senator SHELBY. If the chairman would yield, I also appreciate Mr. Pitt and Mr. Olson who have been working with me on this 2 months now I guess and I do want to add to Mr. Phillips I would appreciate his thoughts and his advice on this because I have some real problems with it and I know they have and they think they've corrected it. I hope you have in some of your drafting, but I'm not sure.

Senator RIEGLE. Well, let's continue to work at it and see if we can do exactly that.

Senator SHELBY. Fine.

Senator RIEGLE. Now let me ask you, Mr. Levine, from an enforcement division point of view, which version would be stronger in terms of comparing our proposal here versus the proposal the Commission brought in today?

SUPPORT FOR S. 1380

Mr. LEVINE. Not being on the enforcement division now——

Senator RIEGLE. But having been there——

Mr. LEVINE [continuing]. But having been there, I don't think there's any question that the S. 1380 is not only a stronger proposal but one which I would strongly urge you adopt. I think we can acquire some benefit from the SEC's proposal certainly in the areas that have been on the conversion side, but the three areas that I think are critical and we really haven't touched on, with all due respect to Senator Shelby, will resolve his question—there are pros-

ecutions going on for 10 years on this and no one has challenged that it can be resolved. You will be satisfied. But if you look at the exceptions that the SEC has put into their bill, as Mr. Phillips identified them, that is not something that Congress can pass and really preserve the SEC's enforcing program in the form they are.

There are holes in a program which are enormous and will be used and abused even if it's not intended by the Commission simply because they are there.

Senator RIEGLE. Before you move on, be very specific now.

Mr. LEVINE. I'm referring now to 3, 4 and 5 D of the Commission's proposal dealing with the questions as to when prohibitions are not applied or when communications are not unlawful. There's a whole identified range, well-intended I think, hearing from the Commission staff and the Commissioner as to what they intended, but they really need to be recrafted in order not to do damage to the enforcement program.

Senator RIEGLE. Before you move on, Mr. Phillips, you're nodding in the affirmative?

Mr. PHILLIPS. Yes. The problem with the exceptions is not simply the exceptions but the prohibition which is so broad as to be unworkable, and requires exceptions that create unintended loopholes. S. 1380 is much better in this respect.

Mr. LEVINE. The second one which I think is important is misappropriation, and we touched on that. I would just say and I think the Commission would concede it, they are concerned about the breadth of misappropriation and yet they say a breach of any personal or other relationship will constitute some kind of act which prohibits you to trade.

And what is important to understand when you're sitting in Gary Lynch's shoes is this exercise sounds good and may be interesting intellectually, but when you've got to prosecute people where people are not cooperating, it's very difficult to do it. If you give standards which you require a judge or a jury to go through six different statutory provisions and try to follow the crime, it becomes very complicated. And that's what the SEC built up, plus I think the way it is drafted, the language, will do damage to the program.

Third, there are areas that are not picked up because of exception and one area which I think has to be picked up, as I speak as an individual and not on behalf of my clients or the SEC, if we, through one of the hypotheticals you never got to, referred to question if someone wants to acquire a corporation but has less than 5 percent tips someone on the street to start acquiring for them and that person not only acquires for the accumulator, if you will, but also acquires for himself, under the SEC's proposal, that is OK, even though it seems to me given the conduct that certainly the public has focused on you would think you would want that addressed and have that prohibited.

Our proposal, which you have certainly put through in S. 1380, addresses that. It will make it unlawful in appropriate ways and not interfere with legitimate activity. The SEC's proposal, in my view, based on the breadth of the exceptions, would not make that unlawful and I think that is an area you should address as well.

Senator RIEGLE. Are there any others that are important to note?

Mr. LEVINE. Well, we have spent some time—I think the questions such as exclusivity and information flow, all of those could be worked out. I really think those are drafting questions.

There are two or three what I view as fundamental questions and I guess I really danced around a little bit through my last comment what I view as a third major role and that is the role of the analysts. It is fine and I believe it strongly—not only because I have clients in that area but because I think it's right—that you have this free flow of information. I forget which Senator started saying, well, it's fine if the corporate executive tells an analyst inadvertently nonpublic information in a whole variety of circumstances—if the analyst does nothing but tells the world, it's OK. If the analyst trades and does nothing else, is that OK? Should that be OK? Under the SEC's proposal, I believe it is OK. It would not be prosecutable and I think that's wrong. If the analyst tells a couple of people, depending on his motive, should that judgment as to whether it's OK or not be based on a prohibition which gives an exception as is in the statute, I think it's wrong. I think you have to give the Commission the authority to address that and what is the sensitive issue here is some people hide that in the guise of hurting market efficiency. I don't think that's right. Corporations want to control when information goes to the public and they should. You don't want a corporate executive to inadvertently tell someone who selectively trades. It doesn't help the corporation.

The pressure point should still be with respect to analysts, as I think the law has developed, which is if they have a legitimate analyst function, they probe and they get information, they give it to the public, that's fine. That is the kind of facilitating of information that you want to do. You don't want to have selected use for the benefit of the analyst or someone else where it will interfere with what I view as legitimate prosecutorial functions.

So I think that is a third area that has to be addressed and I think it can be cured.

Senator RIEGLE. Let me come right down the table to the rest of you.

What would any of the rest of you care to identify as, in your view, major weaknesses of the Commission's proposal?

Mr. OLSON. I think Mr Levine has identified the ones that concern me, Senator Riegle.

Senator RIEGLE. Yes. Mr. Pitt?

WEAKNESSES IN COMMISSION PROPOSAL

Mr. PITT. I think there is one more which I referred to earlier and which is set forth in our statement, and that is vicarious liability on the part of institutions. I have a very serious concern that an organization that has absolutely no contact with a wrongdoer under these statutes, but having made the mistake of hiring them. They have done everything they should in training people, having good procedures and what have you. Their only contact is that they happen to have hired a bad apple, but nevertheless, under the Commission's provision, there is no explicit exemption from liability here.

We have, in S. 1380, provided an express, but very, very narrow way out for that particular situation, and if the Commission were concerned that the firm should be doing more to supervise its employees, all of those remedies would be continued.

I view that, in addition to the ones Mr. Levine has mentioned, a very significant omission in the Commission's proposal.

Senator RIEGLE. Yes. Mr. Phillips?

Mr. PHILLIPS. I agree with what has been said.

In addition, I think we would be concerned with the position of multiservice firms, banks and broker-dealers under the SEC's proposal. Under that proposal, they would violate the statute, if any employee traded on inside information, and that it is a problem, as Mr. Pitt mentioned. But they would also violate the statute, if an employee who did not know of the material nonpublic information traded, and the SEC or a court found that, in some respect, that broker-dealer or that bank did not have adequate policies and procedures to prevent the misuse of information, even though, in that particular case, there was no misuse, and even though, in that particular case, there is no question but the information played no role in the trade, because the employee making the trade may have been located in Hong Kong and the information was in New York. But under the SEC statute, a violation would take place, civil liability, many times the amount of the profits could be imposed, simply because, by hindsight judgment, a court or the SEC found that in some respect, the policies and procedures were defective and not reasonable.

That is not, I believe, the way to deal with the problems of multiservice organizations.

S. 1380, as well as our proposal, we think deals with them effectively. It allows the court to consider the reasonableness of policies but doesn't make what, in effect, is an irrebuttable presumption, regardless of the facts, that if the procedure is found unreasonable, there has been a misuse. That is wrong.

Mr. OLSON. I agree with what Mr. Phillips and Mr. Pitt have said on that point. I think, however, if Mr. Lynch were here, he would say that the SEC wouldn't bring that case and second, he would also tell you, I think, in fairness, that rule 14e–3, which has been on the books now for about 6 years, has exactly the same problem that we have identified with the SEC statute. So this is not a new problem. I agree that the S. 1380 formulation is far preferable, but I think that this is a difference in the category of one that we should be able to work out in the process of negotiations over the next several weeks. I don't think it is a fundamental difference of approach.

Mr. PHILLIPS. Oh, I think it is a critically important difference of approach, and I think that most banks and brokers and other multiservice firms that would have to live under this provision would think so too. They believe in prohibitions against inside trading. They want to comply with the law, but they don't—they can't comply with a law that has no certainty and that has draconian penalties for what may be wholly innocent activities. That can be and should be avoided and is avoided in S. 1380. I don't think this committee should depart one iota from the approach now contained in S. 1380 on that issue.

Mr. LEVINE. Senator, excuse me. I think, from the SEC's vantage point, they don't need it, which is the most important part. They don't really need that provision——

Mr. PHILLIPS. That's right.

Mr. LEVINE [continuing]. Because if they show the knowledge is there, then they win the case. It is what I call window dressing. If they don't show the knowledge there, they should not bring the case, in which case, it shouldn't be there either. So I really think—it is really historical insertion, where there was uncertainty as to what the procedure should be, and it was designed to be a carrot or really a stick to force broker-dealers to adopt procedures.

The Street is well beyond that, and there is not need to have that second leg in there right for the SEC program to succeed.

Senator RIEGLE. Let me ask you this. In light of what the Commission has recommended today, what improvements, if any, do you think we can make and should make to S. 1380? Changes, modifications?

IMPROVEMENTS TO S. 1380

Mr. PITT. I think, and without belaboring the issue too much, we've gone through some of these in more detail in our written statement, but we think that the Commission has done a lot to improve the congressional findings that are a key linchpin of all this. We think that they have dealt with the question of exemptive power, in a way that is satisfactory.

Mr. OLSON. They have gone farther than we did in dealing with private rights of action, dealing with a category that we didn't deal with, and we think the way they dealt with it is generally acceptable. So there are a number of things they have done which, as Chairman Cox said, build on the structure of your bill and Senator D'Amato's, which are suggestions which we think could very easily be incorporated and aren't in any way inconsistent with what you've proposed.

Senator RIEGLE. I think it is important that all of those items be enumerated here, and so, if there are any things that you would like to elaborate on, I would like to have any of you and all of you do so for the record in that respect.

Mr. LEVINE. Well, in terms of the record, we took no position, that is, our group, on some of the items, which I think, such as the second—they have a more expansive remedy than we have, and that is one area. The exclusivity question is another area. The exemptive authority. They've come up differently, and it is there, you know, it is really what they want.

I think you've really gotten the key questions of improvement. Tippee liability is strengthened in certain areas, the way they drafted it, because the sub-tippee questions, if I tell you and you tell someone else. Those are the type of things that have been identified in addition to what John and Harvey have said and can be easily brought in, assuming that we have resolved the big issues.

Senator RIEGLE. Let me ask you this, and we are about to conclude here, and that is, as we narrow things down here in this, and as we get closer to an overlay in the consensus, from where we are today, and looking ahead, what are the one or two or three, sort of

fundamental questions that confront us, where there is some difference here and may prove to be the toughest issues, major questions to settle and the ones that we may have to settle right at the end.

Mr. PITT. You know, it is difficult to predict completely. I think, having heard the testimony today, I was both surprised, and in some respects, gratified to hear Mr. Cox indicate that the possession test vis-a-vis individuals was such a major stumbling block, because I think we, at least, have resolved that problem, and I think we will resolve it as Senator Shelby's benefit, and I think, having heard some of the concerns Mr. Phillips had, I think we could satisfy that, but that is a big area, and I don't want to minimize that.

I think in the area of vicarious liability, that both Mr. Phillips and I have discussed, will be an important area, because sometimes the Commission has staked out a position, and I agree with John Olson, they staked out that position 6 or 7 years ago, and it may be difficult to move them off it, but I think the logic that Ted Levine was just indicating, which suggests they should move off it, but vicarious liability, I think, may be a second major area.

My reaction to most of the rest of it is that the rest of it will all boil down to the formulation of the wrongful standard.

I think what each of the three groups has done, at least conceptually, is the same. That is, I think, with—the intent, is conceptually the same.

I think that, basically, the New York Stock Exchange Legal Advisory Committee and our group, were virtually on all fours. We really saw the issue exactly the same way, which I agree was a remarkable accomplishment, but it was a tribute to the help and encouragement we all got in this process.

I think that the Commission, if it means what it says today, was saying that it has done the same thing, and if so, it shouldn't be a problem. But as we have said in our statement, given the way they have drafted the wrongful standard, and then given the difficult drafting that they have done on d(3), (4) and (5), the exceptions, if they stick to those provisions, then that could become a very difficult area. But conceptually, I think we are a lot closer than, frankly, I had been led to believe earlier. So I think there has been an enormous leap—not a stride, but a leap forward to the goal that you and Senator D'Amato have been pursuing.

Mr. PHILLIPS. Yes. I am also confident that, insofar as the basic definition is concerned, the SEC, the Legal Advisory Committee, and S. 1380, follow the same essential approach. And I think we can sit down with the SEC, find out what their concerns are with the approach of S. 1380 and work with them to resolve them, because our goals, our objectives, our approach are very similar.

The dispute will come in the administration and enforcement provisions, where there will be concern on the part of some people that ease of enforcement is a worthwhile goal, but not at the expense of finding violations by truly innocent persons and by innocent firms. And that problem is going to take some work.

Mr. LEVINE. Senator Riegle, I had a sense from Acting Chairman Cox' testimony that to get to the consensus of getting a definition to the subcommittee was difficult at a Commission level, forgetting about the staff level, that it took a lot of compromise within. I guess, a group of people had different views on what it should be.

And I hope that will not interfere in your goals and this subcommittee's goals. I hope that we will be able to use this hearing and the work of everyone else in trying to work with them and achieve it. That may be something where we are going to have some difficulty, simply because everyone wasn't here and hasn't heard this discussion, but we should work in order to resolve those problems as well.

Senator RIEGLE. Well, I would hope that everyone we have talked about, would have access to this committee record and to read it, because this is an area where facts are important and what people say is important and the exchange of ideas really becomes the foundation for how we get to an answer.

My own thought would be, and I am deeply appreciative of all the work that's been done and the work that is yet to be done as we continue here.

I think we have already reached the point were we clearly have a general vision and point of view that is markedly better than the present law situation. Now, we are not finished because we have got to work it down, so that we have got a solid, tight version that is generally accepted.

My hope would be that if that is so, that in the search for a perfect answer, which may never be quite achievable, that we get as close as we can, in finding that best answer and the one that is clearly better than where we are today with existing law. And if we find, as we get to the end, that there are one or two essentially basic differences of opinion or approach, where it can't be reconciled within this kind of group consensus process, then it seems to me, we will have to see if we can't choose between those, or maybe come up with a third version, or what have you.

I don't know how far we can get here. It would be wonderful if, in the give and take among the professionals in the field, yourselves and the SEC and others, if we could, in the end, have a version where there is a reconciliation that is generally acceptable all around.

If you can do that, that will be a wonderful fact, and if we get very close to that, with one or two outstanding issues, where a choice has to be made, then I think, you know, we need to know that as well.

I would like to see if we can get to the first. Maybe we can and maybe we can't, but I would like to see if we can, and if not, then we will proceed on and see if we can resolve whatever final differences of opinion there are.

Does anybody have any further comment they want to make? Mr. Olson?

ADDITIONAL COMMENTS

Mr. OLSON. One comment, Senator Riegle, and I thank you for your remarks, and I hope we can get there too. If we can't, we will identify for you the issues where there is a difference, and then you will do what legislators have to do, and that is, make some choices.

Senator RIEGLE. Exactly, and we are quite prepared to do that.

Mr. OLSON. I would say the most significant thing I heard this morning was when Gary Lynch sat here, and in response to questions from a somewhat hostile, I would have said, on this subject, Senator Wirth, said that he would be better off in his enforcement program, if S. 1380, as it stands, with the change made in response to Senator Shelby's concerns, were law today. And if we didn't make any other improvements, if we didn't do anything else, his enforcement program would be better off and the law would be better if that law was on the books today.

I think that tells you that you have before you a statute that you go ahead with right now. Now, surely, people will have views as to ways it might be improved, but the most important thing anybody said today was the guy who is running the enforcement program said he would be better off and the law would be better, if that law was on the books today. That tells me that we ought move and not necessarily wait for every single one of us, all of whom are lawyers and accustomed to arguing till the wee small hours, agree on every last comma and word.

Senator RIEGLE. Well, I agree with you that that was a very important statement that he made, and I think it was one of the more important things said today, but I would add something else to it, and that is, when I asked Acting Chairman Cox, speaking as a Commissioner, and not attempting to represent the view of the entire Commission, but only his own view as a Commissioner, if he thought that S. 1380, taken as is, was better than the existing law, I think the record will show that he, too, felt that it was.

Mr. OLSON. You're correct. And so----

Senator RIEGLE. And so, that to me, was a very significant statement on the record by a person of very substantial importance on the Commission itself, in addition to Mr. Lynch.

Mr. OLSON. It may even be more important, because he is not a lawyer. [Laughter.]

Mr. PITT. Senator Riegle, if I—at the risk of prolonging this just another moment, if I may just add one thought, in terms of the methodology, because I think the goal you have indicated is the right one, and I think that it is important that everybody be comfortable as we go down the road, that we have done the best job, and I think we are very close.

It seems to me there are two things. We will all do our part, but I think there are two things, if I may be so presumptuous, to suggest of the subcommittee. I think the first is that what has really driven all of us so far, in part, putting aside the Legal Advisory Committee's own initiative, has been the involvement of the subcommittee, both as a subcommittee, that is, the members, and also the staff. And I think that if there were a framework provided by the subcommittee, which said that—which, in effect, were a directive to the groups, indicating that we go in a certain direction by a certain time, and if we could have the active involvement of the members of the staff, who have really played a very instrumental role in assisting this, in this process, much more so—and they have not sat out here and gotten the recognition for the important efforts they made—but I think if we had both of those things, then I think we can accomplish what you have asked for.

Senator RIEGLE. I think that is exactly on the mark, and we will do that, and you will hear from me in due course, in terms of the ways and means with which to structure that kind of a process, but obviously, with the approval of my colleagues on the subcommittee, it is my intent to do precisely that. And that is to continue to keep this process collected within a framework that lets us keep working and get these answers.

Mr. OLSON. On behalf of all of us, can I thank you for your personal interest, Senator Riegle? It was a significant thing for us that you came to the first meeting of our group and gave us the charge that you did, and that you have continued to have an interest in this on almost a daily basis. We know how busy you are, and we really appreciated the fact that you have been personally involved to a degree that I think is unusual in this kind of a process.

Senator RIEGLE. Well, you are kind to say that. I feel as if I am getting sort of a postgraduate course in the law, in securities law. As a nonlawyer, as a person from a business background, I am appreciating more and more the subtleties and the refinements in the securities law. When you talk about securities lawyers sitting up into the wee hours of the morning arguing the fine points, I am beginning to understand the meaning of that kind of intensity of professional knowledge and experience and concern about what the law is and how the law works.

I think our Government works best when the public sector and the private sector work together. I don't think we are adversaries. It doesn't mean the interests are always the same, but I think when we are laying down patterns of law that are going to govern activities in the public interest and keep a healthy and vigorous private sector, which is so much the secret of the American success, that when we work together, we get better results, as long as everybody comes in with good motives and good will and the ability to sort of listen to the other person and give and take, we can get answers.

When we do that, those are the times when the country has really made a surge. I think this can help us a great deal here.

I appreciate all the hard work, and I appreciate your kind personal comment.

Mr. PITT. And we appreciate your interest.

Senator RIEGLE. The subcommittee is in recess.

[Whereupon, at 12:45 p.m., the hearing was adjourned.]

[Additional material supplied for the record follows:]

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

WRITTEN STATEMENT

OF

THE FINANCIAL ANALYSTS FEDERATION

FOR THE

SECURITIES SUBCOMMITTEE

OF THE

SENATE BANKING, HOUSING AND

URBAN AFFAIRS COMMITTEE

REGARDING

S. 1380

August 28, 1987

I. INTRODUCTION

The Financial Analysts Federation is pleased to submit this written presentation to the Securities Subcommittee of the Senate Banking, Housing and Urban Affairs Committee regarding S. 1380, the Insider Trading Proscriptions Act of 1987 (the "Senate Act" or "S. 1380"), introduced by Senators Donald W. Riegle and Alfonse M. D'Amato on June 17, 1987. This presentation also considers the proposed legislative definition of insider trading submitted to the Subcommittee by the Securities and Exchange Commission in the form of "The Insider Trading Act of 1987," on August 3, 1987 (the "SEC Act"), and the proposed act submitted by the New York Stock Exchange ("NYSE Act").

The Financial Analysts Federation ("FAF"), organized in 1947, is the professional organization for investment managers and securities analysts. The FAF has 56 societies and chapters located in financial centers of the United States and Canada with almost 16,000 individual members. A 57th - international - society includes members in 24 other countries. A sister organization, the Institute of Chartered Financial Analysts ("ICFA"), awards the professional designation Chartered Financial Analyst when three examinations have been passed and certain experience requirements met. More than 10,000 charters have been awarded. Currently there are 5,700 candidates in different phases of the examination program.

Members of the FAF are typically investment managers and securities analysts for broker-dealers, investment advisers,

investment companies, banks, insurance companies, industrial and commercial companies, and pension, endowment and other funds. (These persons are referred to herein as "investment managers and securities analysts.") Further information about the FAF and its activities is contained in Part VI, below.

II. SUMMARY

1. The FAF has had a long history of supporting efforts to prohibit "insider trading" and the communication of "inside information" based both on legal and professional standards. This support includes that of the enforcement program of the Securities and Exchange Commission.

2. The FAF believes that investment managers and securities analysts perform a vital function in the dissemination of corporate, securities and market information and in the operation of fair and efficient capital markets. (A description of the function and role of investment managers and securities analysts is contained in Part IV, below.)

3. The important role of investment managers and securities analysts has been recognized on numerous occasions by the courts and the SEC, most notably in recent years by the Supreme Court in the Dirks case (Dirks v. United States, 463 U.S. 646 (1983)). (Part V, below, elaborates on this recognition.)

4. The FAF strongly believes that any legislative or regulatory proposals on insider trading should recognize the crucial

and appropriate functions and work of investment managers and securities analysts in the investment decision-making process, the flow of corporate and related information, and the operation of the capital markets.

5. The Senate Act does not expressly recognize these functions. The FAF believes that it is imperative for any insider trading act to contain provisions safeguarding these functions and the free flow of information into the investment process. Part III Comments on S. 1380, below recommends that any act contain certain statutory provisions contained in the SEC Act. In addition it is important for Congress and others to recognize these functions in the legislative and regulatory process. The Senate Committee Report seems an appropriate place to expand on managers' and analysts' roles as has been done for prior legislation (e.g., the Senate Banking Committee Report on Proposed Amendments to the Investment Advisers Act in 1976).

6. The Senate Act does not contain a specific recognition of what the profession calls the "mosaic theory". Investment managers and securities analysts collect and evaluate information from a great many sources often over a considerable period of time and their mosaic or model of an industry or company will also progress over time. Managers and analysts communicate extensively with issuers and others to develop a better understanding of the inherent value and prospective worth of a company and its securities. The insights and information so derived may incidentally involve non-

public information which in and of itself is not deemed material. The SEC has long taken the position that the amount of information and detail desired and gathered by managers and analysts is not required to be disseminated by an issuer and in fact would be confusing and burdensome to the average investor to do so.

This composite of information, however, often leads to the construction of a mosaic suggesting a probability scenario, which in turn leads to a judgment by the manager or analyst that is viewed as important. If that assumption or conclusion were correct and had that conclusion been announced by the issuer, it might be material. Nevertheless, the manager or analyst should not be prevented from using the mosaically derived conclusion for investment action that is the result of perceptive research and analysis.

The FAF believes that S. 1380 should contain provisions that expressly recognize and allow this process of astute reasoning by investment managers and securities analysts in such situations. A suggested provision is contained in Part III Comments on S. 1380, below.

7. S. 1380 does not appear to recognize the circumstances explained by the Supreme Court in Dirks where insiders will act consistently with their fiduciary duty in communicating information to managers and analysts (or others) and yet public release of information might affect the market price of securities (i.e. is material). These include instances where corporate officials may mistakenly think the information has already been disclosed or that

it is not material enough to affect the market, or where there is an inadvertent or accidental disclosure.

Investment managers and securities analysts are not now prevented from using this information, nor should they be under any proposed legislation or regulation. The legislative report should make it clear that no such prohibition is intended.

8. The FAF opposes the presumption in S. 1380 that a person who trades while in possession of material nonpublic information is presumed to have wrongfully used that information. While the presumption has been eliminated in a proposed revision of S. 1380, the revision introduces a "possession" rather than a "use" standard. The FAF is opposed to a "possession" standard and believes that, if it is adopted, the "safe harbors" provided in the proposed revision are too restrictive. The FAF suggests alternative provisions in Part III Comments on S. 1380, below, which draw on S.1380 as revised, the SEC Act and the NYSE Act.

9. The Senate Act should be clarified to provide that a tippee is not liable for trades if the tippee did not know (or was not reckless in not knowing) that the tipper had breached a duty.

10. It should be made clear in the legislative report on any legislation that the typical relationship of an investment manager or securities analyst with an issuer in obtaining corporate information is not a "relationship of trust and confidence" as that term is used in the proposed acts.

III. COMMENTS ON S. 1380

A. Introduction

For more than two decades, the FAF has supported efforts to prohibit insider trading and the communication of inside information. It has worked long and hard to inform and educate its members and others regarding these prohibitions and has encouraged compliance with legal prohibitions against insider trading including the SEC enforcement program. Moreover, it has long prohibited insider trading in its Standards of Professional Conduct (which are identical with those of the ICFA). An extensive explanation of the prohibitions as well as compliance procedures to adhere to legal and ethical restraints are contained in the Standards of Practice Handbook[1] published by the FAF and ICFA. (A copy of the Handbook is attached and described in Part VI, below.) The FAF strongly believes that the fairness, integrity of and confidence in the securities markets are seriously eroded by insider trading which should not be tolerated.

In accomplishing this objective, however, the FAF believes that it is essential that the free flow of information into the capital markets not be impaired. In particular, the work of investment managers and securities analysts in pursuing, obtaining and utilizing relevant information by appropriate and legitimate methods in the investment decision-making process should not be curtailed or

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1/ Standards of Practice Handbook, Third Edition, Financial Analysts Federation and Institute of Chartered Financial Analysts (1986).

hampered by uncertainty or concern about potential legal liability based on hindsight. (For a detailed description of the function and role of investment managers and securities analysts, see Part IV, below.)

This important role of investment managers and securities analysts in facilitating the free flow of information to the market place and in the investment process has been recognized and articulated by the courts and the SEC in numerous decisions and other pronouncements since the insider trading cases first commenced in the 1960s. (Examples of this recognition are contained in Part V, below.) Following the decision in Texas Gulf Sulphur in 1968,[2] presentations by corporate representatives to analyst societies were cancelled and communications ceased between a substantial part of the corporate community and individual analysts and managers because of fear and uncertainty about the scope of prohibited activities. This fear gradually lessened as corporate issuers realized that these normal types of communications of corporate information could still appropriately and legitimately continue notwithstanding a lingering uncertainty in the application of the insider trading laws.

However, it was not until the Dirks case[3] in 1983 when the Supreme Court rejected the "abstain from trading or disclose the

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2/ SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d. Cir. 1968), cert. denied sub nom. Coates v. United States, 394 U.S. 976 (1969).

3/ Dirks v. United States, 463 U.S. 646 (1983).

corporate information" rule adopted in Texas Gulf Sulphur (based on possession of material, nonpublic information), and adopted the fiduciary duty rule, did the analytical and investment management profession have some degree of certainty as to the permissible scope of their activities. The specter of potential liability for communication or use of what a court or the SEC determined in hindsight was material, nonpublic information was relieved because of the court's new formulation of the prohibition based on the use of such information resulting from a breach of a fiduciary duty. This gave analysts and managers clearer guidelines in which to pursue their appropriate and important functions in the free flow of information, investment transactions and in the operation of securities markets.

As has been ably described by other commentators in presentations to this Subcommittee, the adoption of fiduciary duty principle was followed by the development of the misappropriation theory to fill gaps in the coverage of the fiduciary duty theory. Acting SEC Chairman Cox stated in his presentation to the Subcommittee on June 19, 1987, that "the Commission does not believe a statutory definition is necessary for the continuing success of its enforcement program".[4] However, he indicated that the Commission could support a definition that would preserve its

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4/ This situation could change, however, depending upon the outcome in the case now pending before the Supreme Court entitled United States v. Carpenter, 791 F. 2d 1024 (2d Cir. 1986), cert. granted, 107 S.Ct. 666 (1986)).

authority and flexibility. (He added that S. 1380 was not such as definition.) At the Subcommittee hearing on August 7, 1987, Commissioner Cox reiterated that while the SEC "does not believe that a statutory definition is, at present, necessary for the continued success of its enforcement program", it recognizes that an appropriately drafted definition can result in benefits.

The FAF is not advocating that any steps be taken to impair or adversely affect the SEC enforcement program for insider trading prohibition. On the contrary, based on the SEC determination of the adequacy of the present state of the law, the FAF is satisfied to accept the current state of the law which it believes satisfactorily recognizes and protects the appropriate function and role of the profession. However, if Congress determines that a legislative definition of insider trading is necessary, the FAF believes that any such legislation must contain certain elements as described below.

B. Wrongful Use and Communication of Information

The Subcommittee now has before it three proposed Acts to define the prohibitions against insider trading. The first is S. 1380 introduced by Senators Riegle and D'Amato ("Senate Act" or "S. 1380"), the proposal submitted by the Securities and Exchange Commission on August 3, 1987 ("SEC Act"), and the proposal submitted by the New York Stock Exchange ("NYSE Act"). Each of these acts would codify the insider trading prohibitions by adding a new Section 16A to the Securities Exchange Act of 1934.

There are many similar structural and substantive features in the three acts. However, the Senate Act (in proposed revised form),[5] and the SEC Act premise liability on the possession rather than the use of material, nonpublic information in insider trading cases. The NYSE Act in contrast is based on the prohibition of the use of material, nonpublic information with a rebuttable presumption that a transaction while in possession of such information will be presumed to have been used unless the trader sustains the burden of proving certain facts in the transaction. The FAF strongly prefers the "use" rather than "possession" approach even if the Act contains, as it should, adequate provisions to protect against inappropriate derivative liability of multi-service firms and to protect the legitimate functions of analysts and investment managers. Suggested provisions are contained in this Part III under Derivative Liability, below.

The FAF believes that the use of the concept, contained in all three proposals, of trading on the wrongful use of information or wrongfully obtained information is a workable concept so long as these terms are adequately and appropriately defined and there are adequate safeguards on their application.

C. Breach of Duty Standard

The three proposed acts base wrongful use and wrongful communication of information on two types of activities. The first

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5/ The authors of S. 1380 have submitted to the Subcommittee a proposed elimination of presumption language (and other changes) in S. 1380 in response to concerns raised by Senator Shelby.

category is variously phrased including terms as "theft", "bribery", "conversion" and "misappropriation". These are efforts to codify the "misappropriation theory" which has developed in the courts in the last several years and is involved in the Carpenter case now pending before the Supreme Court. The FAF supports the inclusion of that concept in any legislation.

The second category bases liability on a breach of duty of specified types of relationships including (from S. 1380) "fiduciary, contractual, employment or other relationship of trust and confidence".

The FAF strongly supports the "breach of duty" approach and has encouraged its use for more than 15 years including its adoption in the Dirks case. The FAF agrees with the other commentators to this Subcommittee who advocate that the focus should be on the conduct of insiders rather than on information per se and its possession.[6]

However, the FAF recognizes that such a "breach of duty" standard will leave to the courts and the SEC the task of applying it in individual cases. Therefore, it should be made clear in the legislative report on any legislation that the typical relationship of an investment manager or securities analyst with an issuer or other communicators of information is not a "relationship of trust and confidence" as that term is used in the proposed acts.

6/ See, SEC Commissioner Smith's concurring opinion, In re Investors Management Co., 44 SEC 633, 648 (1971).

Moreover any proposed act should clearly provide (which S. 1380 does not now do), that a tippee is not liable for trades only if the tippee knows (or is reckless in not knowing) that the tipper has breached the designated duty. The legislative report should make it clear that the duty is not breached if the communicator believes that the information is not material, or is already public or the disclosure is inadvertent.

D. Derivative Liability

The FAF has consistently over more than twenty years urged employers in the financial community to adopt procedures designed to prevent and detect legal and ethical violations. Each chapter of its Standards of Practice Handbook (described in Part IV, below), includes a section on such compliance procedures. Not only are these procedures important to prevent legal violations but are considered by the FAF to be important features of good professional practice.

Accordingly, the FAF strongly favors provisions that exempt an employer from liability if the employer has taken reasonable steps to prevent violations of the insider trading prohibitions by employees. Such provisions are in two categories.

First, the FAF strongly favors the provision in the NYSE Act which exempts persons (i.e., employers) from liability based solely on the fact that such persons employed another person who has violated the insider trading prohibitions. (NYSE Act Subsection (d)). A similar provision is contained in the Insider Trading Sanctions Act (Securities Exchange Act Section 21(d)(2)(B)).

The second category of provisions relate to presumptions regarding liability or affirmative defenses to avoid liability. S. 1380 contains a presumption which was questioned by Senators at the Subcommittee hearing on June 17, 1987. A revision by the authors of S. 1380 was thereafter submitted removing the presumption and inserting an affirmative defense. (This revision is referred to as the "S. 1380 Revision"). The SEC Act also contains affirmative defense provisions and the NYSE Act contains a rebuttable presumption.

The FAF has carefully considered these alternatives especially in light of its desire that the SEC's enforcement program against insider trading violations not be impaired. The FAF has concluded that it strongly opposes any presumptions and favors appropriately drafted affirmative defenses. The FAF's proposal described below adopts elements of the three other proposals.

First, no liability should be imposed on a natural person if such person sustains the burden of proving that:

> the purchase or sale of the security was not influenced by such material, nonpublic information.

There are many examples of circumstances where a person may obtain material nonpublic information and should not, as a matter of policy, be barred from engaging in securities transactions. Some examples include automatic reinvestment programs and preformulated computer trading programs. Individuals should not be penalized by imposing liability or requiring non-action in these circumstances.

Moreover, there are other situations where a person's trading decision is not influenced by material, nonpublic information in his or her possession. For example, an analyst or manager might have made the investment decision but it is not yet implemented before receipt of such information. Such person should have the right to prove that the information did not influence the decision. The FAF believes that this is too important a matter to leave to subsequent SEC rulemaking (dispute its respect for the SEC) as has been suggested to this Subcommittee.

In the case of persons other than natural persons (i.e., entities including multi-service firms referred to as "employers" herein), the FAF believes that such employers should be entitled to the same affirmative defense as an individual. Thus, if the employer can prove that the trading decision was not influenced by the material nonpublic information it should not be liable. (It is especially relevant that the employer has adopted policies and procedures to prevent violations.)

E. Mosaic Theory

The Senate Act does not contain a specific recognition of what the investment management and analytical profession calls the "mosaic theory." Investment managers and securities analysts collect and evaluate information from a great many sources often over a considerable period of time and the resulting mosaic or model of an industry or company will also progress over time. Managers and analysts communicate extensively with issuers and others to

develop a better understanding of the inherent value and prospective worth of a company and its securities. The insights and information so derived may involve some nonpublic information which in and of itself is not deemed material. (The SEC has long taken the position that the amount of information and detail desired and gathered by managers and analysts is not required to be disseminated by an issuer and in fact would be confusing and burdensome to the average investor if the issuer did so.)

This composite of information, however, often leads to the construction of a mosaic suggesting a probability scenario, which in turn leads to a judgment by the manager or analyst that is viewed as important. If that assumption or conclusion were correct and had that conclusion been announced by the issuer, it might be material. Nevertheless, the manager or analyst should not be prevented from using the mosaically derived conclusion in communications or for investment action that is the result of perceptive research and analysis.

The FAF believes that S. 1380 should contain provisions that expressly allow or recognize this process of astute reasoning by managers and analysts in such situations. The FAF suggests the following provision for insertion in the Act:

> No person shall be liable under this Section solely by reason of the fact that such person uses nonmaterial, nonpublic information to arrive at a material assumption or conclusion [which material assumption or conclusion would,

if wrongfully communicated or wrongfully used as defined in this Section, be a violation thereof, and uses or communicates such material assumption or conclusion.

F. Recognition of the Role and Function of Investment Managers and Securities Analysts

The FAF strongly believes that any legislative or regulatory proposals on insider trading should recognize the crucial, appropriate and in some respects unique functions and work of investment managers and securities analysts in the investment decision-making process, the flow of corporate information and the operation of the capital markets.

S. 1380 does not expressly recognize these functions. The FAF believes that it is imperative for the Act to contain certain provisions outlined below, as well as for Congress and others to recognize these functions in the legislative and regulatory process. In addition to the provisions in the Act, the FAF suggests that the Senate Committee Report seems an appropriate place to expand on the managers' and analysts' roles as has been done in prior legislation (e.g., The Senate Banking Committee Report on Proposed Amendments to the Investment Advisers Act in 1976.)

The SEC Act (but not S. 1380 or the S. 1380 Revision), does include important and necessary provisions to recognize the role and

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7/ The FAF favors the materiality test in Texas Gulf Sulphur, which applies to "those situations which are essentially extraordinary in nature and which are reasonably certain to have a substantial impact on the market price of the security if the extraordinary situation is disclosed". 401 F.2d at 848.

function of investment managers and analysts. Subsection (d)(3) of the SEC Act provides that communications made in a reasonable effort to make information public is not unlawful.

This is a sound provision as managers and analysts are often caught in a dilemma if they have received what might with hindsight be considered material, nonpublic information or information wrongfully communicated to them. They are immobilized from acting on the information, or if they act it is only at their peril. The FAF has encouraged members to take reasonable steps to accomplish public dissemination of the information.[8] This is usually done by urging corporate management to announce the information publicly. Failing that, however, and especially if corporate management does not believe that the information is material or believes that it is already public, analysts and managers should not be prohibited from taking steps to remove the constraints placed on them inadvertently or otherwise by issuers.

It is to be emphasized here, however, that the FAF has (along with many others) long advocated that important corporate information be timely disclosed by issuers, and that it is the responsibility of issuers to disseminate important corporate information not the responsibility of analysts or managers. This provision of the SEC Act should be included in any final legislation as it maintains the free flow of information.

8/ Standards of Practice Handbook at 24 and 31.

The SEC Act also contains provisions in Subsections (4) exempting communications to or by persons engaged in the business of analyzing and disseminating information concerning securities, the markets for securities or the financial condition of issuers, and in subsection (5) exempting certain authorized transactions.

The FAF is strongly in favor of these provisions and applauds the SEC for including them as it indicates an astute perception of the work on analysts. Again such provisions stimulate the free flow of information and removes impairments on analysts in this process.

G. Summary of Proposed Recommendations .

The FAF supports inclusion in any act on insider trading of the following provisions which are discussed in this Part III, above.

Any act should provide:

1. That the prohibition apply to "use" of material, nonpublic information rather than "possession" of such information. If this provision is not contained in the act then the provisions specified in D. above, and summarized in this Part G.4., below, should be included. (See Part III B, above.)

2. The legislative report for any act should state that the typical relationship of an investment manager or securities analyst with an issuer or communicators of information is not a "relationship of trust and confidence" as the term is used in the act. (See Part III C., above.) The report should also describe the role and function of investment managers and security analysts.

3. Any act should clearly provide that a tippee is liable for trades only if the tippee knows (or is reckless in not knowing) that the tippee has breached the designated duty. (See Part III C., above.

4. If the "possession" standard is adopted rather than the "use" standard, any act should provide an affirmative defense for all persons, whether natural or non-natural, that the transaction was not influenced by the material, nonpublic information. (See Part III D., above.)

5. Any act should contain a provision exempting trading on the basis of or communicating conclusions reached as a result of perceptive analysis, a process commonly known as the "mosaic theory" (See part III E., above.)

6. Any act should contain the provisions contained in the SEC Act subsections (3) (4) and (5) exempting certain communications and action. (See Part III F., above).

IV. FUNCTION AND ROLE OF INVESTMENT MANAGERS AND SECURITIES ANALYSTS

Analysts and investment managers function in a variety of contexts. They work for broker-dealers, investment advisers, investment companies, banks, insurance companies, industrial and commercial companies, and pension, endowment and other funds. Securities analysts typically will search for, assemble and evaluate information about securities and issue reports and investment recommendations both to individuals and to institutional customers.

investment managers utilize the research of others and their own investment experience and analysis in making investment decisions on behalf of their clients or employers. A description of this process is contained in the FAF submission to the SEC in 1971 in response to its request for proposed guidelines on inside information:[9]

> Financial analysis encompasses all aspects of investment policy formation, security analysis, and portfolio management. The financial analyst gathers and interprets large quantities of information from many sources to fulfill his obligation to clients and the public at large, thereby maximizing the efficiency of the capital markets.
>
> The investment process may start with efforts to detect, understand and anticipate changes (including those politically initiated) in the economy, the securities markets and various industries. With respect to equities, it is well known that two important causes of price changes are changes in the level of the stock market generally and changes in the fortunes of the company's industry. Unique factors relating to an individual company's stock are usually of lesser importance.
>
> The analyst is expected to judge an industry's prospects by knowing the fundamentals well. He should understand how the industry's volume, price realizations and operating costs are influenced by changes in economic activity, inflation, controls and other variables. He develops this knowledge and comprehension by following an industry over a period of years, learning the complicated but interrelated impact of changing circumstances on a company, its competitors, suppliers and customers. For example, one company's customer is frequently another company's supplier.

9) SEC Rel. No. 34-10116, August 3, 1973; Financial Analysts Federation Guidelines on Inside Information, Financial Analysts Journal, January-February 1974.

> While a company's progress, measured by either its business volume or its security price, may be importantly influenced by broad macroeconomic factors, each company has its individual characteristics. There may be comparability among firms in an industry but never exact similarity. Foreign exposure, competitiveness of product lines, pricing flexibility, efficiency, cost controls, tax rates, financial position, accounting practices and the historical financial record are only a few of the variables that differentiate companies. The analyst combines his understanding of these many dynamic variables to estimate, among other key factors, future earnings and dividends.
>
> However, the analyst's review at this point is not complete. Even after estimating future earnings and dividends, he must assess the price at which a security may sell. The price/earnings ratio contributes importantly to the variability of a particular security's price, and as a part of his work the financial analyst must make this essential value judgment.
>
> Notwithstanding all the analytical effort, the analytical process nevertheless lacks perfection because the future cannot be known with certainty. Consequently, the decision maker strives to protect the portfolio by diversifying among a number of different issues. Clearly, the nuances of equity investment are many and varied. To excel requires skill, hard work, and a sensitive intuition."

Another description of the "Methodology of Investment Analysis is contained in a letter from a former FAF Executive Director (writing for his private firm) to the SEC also in connection with the SEC Guidelines project.

> "Investment analysis is directed to identifying change and change in the rate of change in the earning power and financial position of a company. A typical analysis begins with a review of the company's history, products, markets, operations, earnings and financial position. Data for the firm are then related to

information about the industry in which it operates, its competitors within that industry, and to the general economy in order to determine the dynamic relationships between the firm and its environment. Analysis of the individual firm must also encompass management and its decision-making philosophy, marketing capabilities, production facilities, and changes in all of these elements as they have occurred over time.

The many elements of an investment analysis must be summarized and expressed in quantitative terms. Investors generally consider net earnings as the best measure of a company's performance and indicator of value in most continuing enterprises. The quality of earnings is tested by the concepts of normality (i.e., what a company might earn under normal economic conditions absent strikes, floods, wars and the like); extraordinary earnings from special non-recurring events in the company; the trend over a 5 or 10 year period or a succession of business cycles; and stability or variability from year to year around the trend line. All the facets of earnings add up to the concept of earning power which may be defined as the ability of the company to produce continuing earnings from the operating assets of the business over a period of years. It is not fixed but will change with changes in management, the life cycle of industries and other long-term factors. Investors are constantly on the alert to catch incipient shifts in the direction of earning power and consequently even small variations in earnings, depending upon their cause, can have a magnified impact on investor expectations.

The historical record is the basis for an evaluation of management's ability to plan and to take advantage of economic opportunity or defend itself against economic adversity. It also is the base from which the investor makes his estimate of earning power over future periods--one, three, and perhaps five years. The estimating process moves from the general to the particular, starting with the outlook for the economy and the industry. Detailed analysis of new markets, new capital investment, new technology, regulatory changes, price trends, and many other factors follows. Their impact on the company is measured through the financial

statements. The analytical conclusion usually is cast in the form of a forecast of earnings, dividends, and financial requirements for the period ahead. In a dynamic economy, the margin of error in such forecasts is bound to be considerable but nevertheless, investors base their decisions on expectations of the future.

This kind of future oriented information is not readily available to the outsider in convenient brochures or corporate plans. Much of it must be pieced together from various sources, making inferences based on past experience. Projective information supplied by the company is subject to considerable error and must be checked against other information. In these circumstances a piece of information can be considered extremely important by one analyst and of little importance by another, depending on their analytical frameworks. Or, information which was deemed important on one occasion may be assigned little weight in a different context.

The investor must make not one forecast but many since his objective is to make effective disposition of his funds by choosing from alternative investments. He seeks the highest available total return (dividends and appreciation) within desired risk constraints. Therefore, investment analysis is comparative between companies in the same industry, between different industries, and over time. [10]

Not only are analysts important in the process of dissemination of information about issuers and securities through their research products, but the role of the investment manager in making and effecting investment decisions has become an integral part of the operation of fair and efficient markets. This has been explained by former SEC Commissioner Bevis Longstreth in a speech to the 1987 FAF Conference. Mr. Longstreth summarized some of the themes in his

[10] Letter of William C. Norby, CFA of Duff and Phelps, Inc., August 31, 1973.

book Modern Investment Management and the Prudent Man Rule[11] which traces the development of investment practices since the mid-19th century:

> The shrinking use since 1961 of inside information as a feasible tool of the investment trade coincides with the emerging dominance of the institutional investor, the coming of age of the financial intermediary, and the recognition that our capital markets are in a broad sense efficient.
>
> * * *
>
> By making mandatory a uniform system of financial disclosure, the securities laws provided grist for the security analyst's mill. ... Today, the efficiency of our capital markets is much more a product of rapid dissemination of information, its analysis by professionals, and the investment decisions of institutional investors relying on that analysis than of the trading by insiders and those with special access to insiders. Over the years, the security analyst has replaced the inside source as the key to sound investment choice within an actively managed portfolio.[12]

V. RECOGNITION OF THE ROLE OF INVESTMENT MANAGERS AND SECURITIES ANALYSTS

The courts and the SEC have in several judicial and administrative decisions and other pronouncements recognized the vital, appropriate and legitimate role of investment managers and securities analysts in the operation of fair and efficient markets. Some examples of these are set forth below.

11/ Longstreth, Modern Investment Management and the Prudent Man Rule, Oxford Press (1987).

12/ Address by Bevis Longstreth, "Fiduciaries, Capital Markets and Regulation - the Current Challenge," 1987 FAF Conference, May 12, 1987.

In SEC v. Bausch & Lomb, Inc., the District Court stated the matter as follows:

> "At the heart of this controversy is a question of the permissible scope of communications between a corporate officer and securities analysts. Analysts provide a needed service in culling and sifting available data, viewing it in light of their own knowledge of a particular industry and ultimately furnishing a distilled product in the form of reports. These analyses can then be used by both the ordinary investor and by the professional investment adviser as a basis for the decision to buy or sell a given stock. The data available to the analyst - his raw material - come in part from published sources but must also come from communications with management.
>
> Both the NYSE and the SEC have encouraged publicly traded companies to maintain an 'open door' policy toward securities analysts.[13]

The court then quoted from the SEC decision in Investors Management Co., Inc.[14] stating that the Commission acknowledged the role of analysts and the potential benefit of meetings between them and corporate officials.

> "We appreciate the concerns that have been expressed about the need to facilitate the free flow of information throughout the financial community. We have consistently required or encouraged the broadest possible disclosure of corporate information so as to provide public investors and their professional financial advisers with the most accurate and complete factual basis upon which to make investment decisions. We also recognize that discussions between corporate management and groups of

13/ 420 F. Supp. 1226 at 1230 (S.D.N.Y. 1976). See also references in the Court of Appeals decision 565 F.2d 8 footnotes, 2 and 6 (2d Cir. 1977).

14/ SEC Rel. No. 34-9267 (July 29, 1971) [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶78,163.

> analysts which provide a forum for filling interstices in analysis, for forming a direct impression of the quality of management, or for testing the meaning of public information, may be of value." 16/

The Court then quoted extensively in a footnote from the panel discussion at the PAF 1968 Fall Conference in which the SEC General Counsel, later Commissioner, Philip A. Loomis, Jr., answered wide-ranging questions about corporate disclosure and analysts.17/ For example, Mr. Loomis stated:

> I don't think that the mere fact that [corporate information] has not already been disseminated - perhaps because the company doesn't want to send their stockholders something the size of a telephone book - makes it improper for them to tell an analyst." 17/

Recently, in the Dirks case,18/ the Supreme Court considered at length the important role of analysts and other market professionals. The following quotation from the opinion illustrates the Court's concern with the impact of the then existing rule on analysts.

> Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market. It is commonplace for analysts to 'ferret out and

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15/ Bausch & Lomb, 420 F.Supp at 1230.

16/ "Corporate Disclosure and Insider Information", Financial Analysts Federation (1968).

17/ Bausch and Lomb, 420 F.Supp. at 1231.

18/ Dirks, 463 U.S. 646.

> analyze information,' and this often is done by meeting with and questioning corporate officers and others who are insiders. And information that the analysts obtain normally may be the basis for judgments as to the market worth of a corporation's securities. The analyst's judgement in this respect is made available in market letters or otherwise to clients of the firm. It is the nature of this type of information, and indeed of the markets themselves, that such information cannot be made simultaneously available to all of the corporation's stockholders or the public generally. [19]

The Court, in several footnotes, elaborated on the importance of the analyst's function and the need for clarity regarding permissible conduct:

> "The SEC expressly recognized that '[t]he value to the entire market of [analysts'] efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by [their] initiatives to ferret out and analyze information, and thus the analyst's work redounds to the benefit of all investors'.[20]
>
> ... The SEC asserts that analysts remain free to obtain from management corporate information for purposes of filling in the 'interstices in analysis'. ...But this rule is inherently imprecise, and imprecision prevents parties from ordering their actions in accord with legal requirements. Unless the parties have some guidance as to where the line is between permissible and impermissible disclosures and uses, neither corporate insiders nor analysts can be sure when the line is crossed. ...
>
> The SEC's rule - applicable without regard to any breach by an insider - could have serious ramifications on reporting by analysts of investment views.

19/ Id at 658.

20/ Id. at 658. Citing In re Raymond Dirks, 21 SEC Docket 1401, 1406 (1981).

> Despite the unusualness of Dirks' find, the central role that he played in uncovering the fraud at Equity Funding, and that analysts in general can play in revealing information that corporations may have reason to withhold from the public, is an important one. Dirks' careful investigation brought to light a massive fraud at the corporation. And until the Equity Funding fraud was exposed, the information in the trading market was grossly inaccurate. But for Dirks' efforts, the fraud might well have gone undetected longer. [21]

The Court then discussed typical situations which might occur in an analysts interview.

> In some situations, the insider will act consistently with his fiduciary duty to shareholders, and yet release of the information may affect the market. For example, it may not be clear - either to the corporate insider or to the recipient analyst - whether the information will be viewed as material nonpublic information. Corporate officials may mistakenly think the information already has been disclosed or that it is not material enough to affect the market. Whether disclosure is a breach of duty therefore depends in large part on the purpose of the disclosure.
>
> Thus, the test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach [by the tippee]. [22]

VI. THE FINANCIAL ANALYSTS FEDERATION

The Financial Analysts Federation is the professional organization for securities analysts, portfolio managers, investment

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21/ Id at 658.

22/ Id. at 662.

counselors, managers of pension, endowment, mutual, and other funds, and others who make or recommend investment decisions. The FAF has almost 16,000 individual members who are affiliated with 56 societies and chapters in the United States and Canada. A recently formed (57th society) international group provides membership in the FAF for professionals practicing outside the United States and Canada. Presently 90 percent of the membership is in the United States, nine percent in Canada, and one percent elsewhere.

Members of the FAF work for broker/dealers and investment bankers (23%), trust departments and other units of banks (20%), as investment counselors (21%), and for insurance companies (10%). Members are also employed by pension and endowment funds, industrial companies, educational institutions, and government.

The FAF was founded in 1947 with three major objectives:

1. To supplement efforts of government and the private sector to ensure that investors have the information they need to make responsible investment decisions;

2. To promulgate a Code of Ethics and Standards of Professional Conduct, maintain their relevancy, and enforce compliance;

3. To define a body of knowledge for those who make investment decisions and develop a curriculum and an examination process.

A. FAF Activities

1. Quality of Information Available to Investors

A committee on Corporate Information was one of the first the FAF constituted. Since 1947 that committee has mounted an extensive program to review the status of corporate reporting within industries as well as of individual companies. This year the reporting of more than 500 companies will be reviewed on the basis of industry criteria that subcommittees have developed. Findings are published annually. Awards for Excellence in Corporate Reporting are presented to companies that set industry standards for outstanding reporting practices.

The FAF was one of the founders of the Financial Accounting Standards Board ("FASB") and continues to be one of its sponsors. FAF committees respond to FASB releases as well as to those of the SEC and other bodies on accounting and disclosure issues that impact the quality of information available to investors.

2. Prevention of Insider Trading

In the turbulent years between 1968 and 1974, the FAF took several initiatives to outline the analyst's role in the investment process and to underscore the strength and stability analysts foster in the market as they participate in the dissemination of information. The FAF called its first press conference in September 1968 following reports that some corporations either were slowing down or shutting off the flow of information in the wake of what was then being called a "crisis in information" and an SEC crackdown on

inside information. The following month the SEC General Counsel, Philip A. Loomis, Jr., was interviewed by a panel of securities analysts at the FAF's Fall Conference. Some 25,000 copies of the resulting discussion were distributed. (A second panel featuring Mr. Loomis was later formed, with the results published in the FAF's Financial Analysts Journal, May-June 1972. The Journal is described below.)

The 1976 Bausch & Lomb, Inc. case[23] quoted the October 1968 panel discussion in a lengthy footnote. The opinion also commented favorably upon what analysts call the "mosaic theory".

In 1973 the FAF formed a special Ad Hoc Committee on Inside Information. Twelve "guidelines" were submitted in response to its request.[24]

A section of General Comment in the submission summarized the FAF's view of the analyst's role in the dissemination of information. It read:

> Efficient capital markets contribute to a productive allocation of financial resources. Financial analysts, their research, advice and portfolio management, play an essential role in this process. It is in the public interest to encourage analysts and investors to pursue their quest for information from all available sources so as to permit achievement of the highest standards of service and the best informed investment judgments. It is also in the public interest and basic to the SEC's policy of full disclosure for corporations to maximize public

23/ Bausch & Lomb, 420 F.Supp. 1226.

24/ SEC Rel. No. 34-10316, August 1, 1973.

information disclosure and to disclose promptly all important information.[25]

In a series of 21 articles published between 1971 and 1986, the FAF's Legal Counsel has kept the membership and others who subscribe to the Financial Analysts Journal informed about changes in laws, rules, and practices.

The longest chapter and perhaps the most fully referenced and footnoted of the chapters in the Standards of Practice Handbook (described below) is on the Standard II C, which prohibits the use of material, nonpublic information. The Handbook, first published in 1982, is now in its third edition with preliminary work underway for a fourth edition to be published in 1988.

3. Code of Ethics and Standards of Professional Conduct

A workable Code of Ethics was adopted in 1962 and set the framework for the current Code of Ethics and Standards of Professional Conduct. A joint committee of the FAF and the ICFA meets twice yearly to review the Code and Standards and to recommend any changes deemed necessary. Since 1982 a Standards of Practice Handbook has been available to assist members of both organizations and others to apply the Code and Standards in daily investment decision-making. The Handbook has been translated by the Securities Analysts Association of Japan as a first step in that group's effort to develop ethics and conduct standards of its own.

25/ FAF Guidelines, Financial Analysts Journal, January-February 1974.

The Handbook has been widely quoted, particularly its sections on Standard II C, Prohibition Against Use of Material Nonpublic Information, and Standard VII C, Fiduciary Duties.

Moreover, the FAF has a vigorous program of enforcement of its Code and Standards. Potential violations are investigated and processed with sanctions applied against members if violations are found. Each member is obligated to submit an annual report each year disclosing certain matters relating to professional conduct. If a person is a member of both the FAF and ICFA the matter is processed jointly.

4. Chartered Financial Analysts Designation

To reach its goal of defining what investment analysts need to know, FAF retained Ezra Solomon, then on the faculty of the University of Chicago, to outline a required body of knowledge and an examination structure to test. In 1962, in order to ensure concentrated attention, the FAF organized a separate body, the Institute of Chartered Financial Analysts, to oversee the educational program. The widely recognized designation "Chartered Financial Analyst" (CFA) is awarded after completion of a series of three annual examinations and three years' experience in financial analysis related to investment decision-making. Since the first CFA examinations were given in 1963, some 53,000 examinations have been given and more than 10,000 charters granted. Since 1977 all new regular members (Fellows) of the FAF are required to pass the first of the examinations.

B. Other Activities

The FAF also publishes the respected Financial Analysts Journal, a bimonthly, and sponsors seminars, workshops, and conferences to provide continuing education opportunities for its members and the public.

The FAF has long had interest in investment worldwide and exerted international leadership. In 1974 this led to the formation of the International Coordinating Committee of Financial Analysts Associations, which presently links analysts societies in more than two dozen nations in efforts to harmonize accounting practices, develop recognized ethical and conduct standards, and define a workable approach to an international system of education and accreditation of investment analysts.

C. Institute of Chartered Financial Analysts

In addition to administering the CFA examinations, the Institute of Chartered Financial Analysts maintains constant review of the curriculum and body of knowledge. To help keep present holders of the CFA designation and others alert to changes in the nature and methodology of investing as well as to changes in securities law, accounting and disclosure standards, and ethical and practice standards, as well as to expand the body of the knowledge tested, the ICFA holds seminars from which proceedings are printed and made available to candidates, members, and the public. Some 60 universities have adopted a recent publication on Managing Investment Portfolios as a standard text.

The Financial Analysts Federation has offices at 1633 Broadway, 14th Floor, New York, NY 10019 (212-957-2860) and Charlottesville, VA, where it shares facilities with the Institute of Chartered Financial Analysts at 5 Boars Head Lane, 22903 (804-977-6600).

The President and Chief Executive Officer of both organizations is Alfred C. Morley, CFA.

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